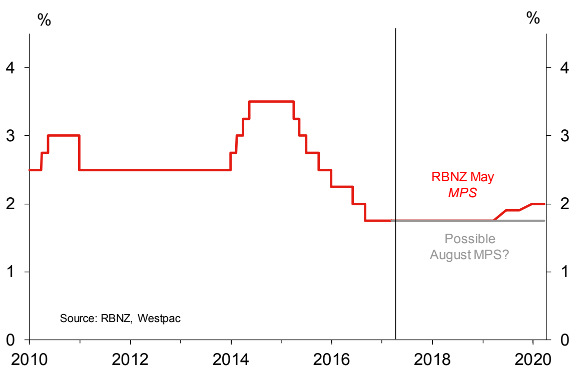
Against the tide

Monetary Policy Statement preview, August 2017

4 August 2017

- We expect the RBNZ will leave the OCR at 1.75% and reiterate that monetary policy is on hold for the foreseeable future.
- The press release will probably emphasise the softer tone to recent data, and the RBNZ's discomfort with the high exchange rate.
- The RBNZ may expunge any hint of hikes from its OCR forecast, and issue slightly more dovish guidance in the press release.
- An MPS along these lines would surprise financial markets, possibly causing swap rates and the exchange rate to fall on the day.

RBNZ Official Cash Rate forecasts



The Reserve Bank has been studiously neutral about the interest rate outlook in recent months. Its written commentary has given little away, other than to state that the OCR is expected to remain low for a long while yet, and that there are numerous uncertainties which policy may need to adjust to. In a May media interview, Assistant Governor John McDermott was blunter – he said there is an even chance of a rate hike or a cut in the future.

All this is a far cry from financial market pricing, which suggests that the RBNZ is going to start increasing the OCR from mid-2018. The markets' logic is that the RBNZ will eventually be forced to swim with a tide of rising interest rates, led by the US Federal Reserve.

At next week's *Monetary Policy Statement (MPS)*, we suspect the Reserve Bank will reveal that its thinking has shifted even further from financial market pricing. The RBNZ probably doesn't intend making a big splash at this point, but we still expect that the tone of the *MPS* will surprise markets, and could cause a drop in swap rates and the New Zealand dollar on the day.

After sifting the latest data, the Reserve Bank is probably now even less likely to countenance the idea of OCR hikes than it was before. There has been a run of developments that will make it harder for the RBNZ to bolster inflation:

- **The housing market has weakened further.** Prices fell 3.3% in Auckland over the first half of this year, price gains have slowed elsewhere, and plunging market turnover suggests the market could weaken further in the months ahead.
- **The building boom has lost some steam.** Nobody expected it, but the fact is that building consent issuance has levelled out, indicating that overall house building activity could soon slow.
- **GDP growth has been underwhelming.** March 2017 was the third consecutive quarter in which the economy grew more slowly than anticipated, and the latest indicators suggest that June quarter growth was below the RBNZ's expectations too.
- **The exchange rate has popped higher.** Some of the recent rise in the exchange rate was justified by the improving fortunes of the nation's farmers, but 74 cents against the US dollar is beyond the pale and will concern the Reserve Bank.

- **Inflation was lower than expected.** Inflation dropped to 1.7% in June, when the RBNZ expected it would be 2.1%.

Also worth mentioning is a recent speech in which the RBNZ signalled that its estimate of the "neutral" OCR has fallen. All else equal, a lower neutral OCR implies that the RBNZ will have to keep the actual OCR lower in order to stimulate inflation.

Of course, there have been positive developments that could be used to bolster the case for OCR hikes. In its May *Budget* the Government outlined plans to cut taxes and boost family income support. Farmers are feeling happier now that dairy and lamb prices have lifted. And net immigration remains as strong as ever. The trick for monetary policy is to weigh the positives against the negatives, and on this occasion we are fairly confident that the negatives will have won out in the RBNZ's models and deliberations.

The tenor of recent developments may be clear, but on this occasion we suspect that the RBNZ will want to avoid making any big splashes. Any shift in its rhetoric or OCR forecast will probably be mild.

The looming general election has cast a pall of uncertainly across economic forecasts. Another key uncertainty is whether or not the housing market will spark back to life. The RBNZ will probably want to avoid big changes to its key messages when the outlook could change again within months.

In addition, the Reserve Bank may be conservative ahead of its own leadership handover. The current Governor will leave in September, to be replaced by a caretaker Governor on a six-month term. The process of finding a new permanent Governor will begin after the September election.

Tone of the Statement

In the one-page press release accompanying next week's *Monetary Policy Statement*, we suspect that the Reserve Bank will continue with the same "bottom line" guidance as it used in June:

"Monetary Policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly."

More-or-less the same guidance has been used at every *MPS* or OCR Review this year, and is basically code for "the OCR is on hold." The current situation does not warrant any change to that very fundamental message.

But there are a number of other ways that the RBNZ could get across the point that the outlook has softened. The penultimate sentence of the press release has, in the past, been used to summarise the tenor of recent developments. That format could be resurrected with a sentence like:

"Developments since the May Monetary Policy Statement *have on balance softened the outlook for medium term inflation."*

Another important communication device might be to focus on downside risks in the alternative scenarios that the RBNZ usually publishes in the *MPS*, and in the policy assessment chapter of the *Statement*.

The one area where we do think the RBNZ will want to be more forthright is the exchange rate. The recent rise to 74 cents against the USD seems out of proportion with New Zealand's economic conditions, and the RBNZ will not be shy of saying so. The RBNZ could even go so far as to say that if the exchange rate remains too high, monetary policy would have to be more accommodative than otherwise – terminology that it has used in the past.

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