

Tumbling Kiwi keeps RBNZ on track

MPS preview November 2017

2 November 2017

- We expect the RBNZ to keep the OCR on hold and give the same neutral policy guidance that it has given all year.
- We expect the OCR forecast to be the same as the August MPS – flat until 2019 and slowly rising beyond that.
- The economic outlook has deteriorated, and the housing market is weaker than the RBNZ anticipated.
- But the exchange rate has fallen sharply, meaning the overall outlook for medium term inflation is broadly unchanged.
- The change of Government makes the economic outlook more uncertain. The RBNZ is better off waiting and seeing how Government policy evolves, rather than making bold changes at this point.
- There would be very little financial market reaction to a neutral MPS along these lines.

Since early this year the RBNZ has been the Switzerland of central banks, remaining strictly and consistently neutral. The RBNZ has repeated the same bottom-line guidance paragraph, more or less unchanged, since February this year:

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

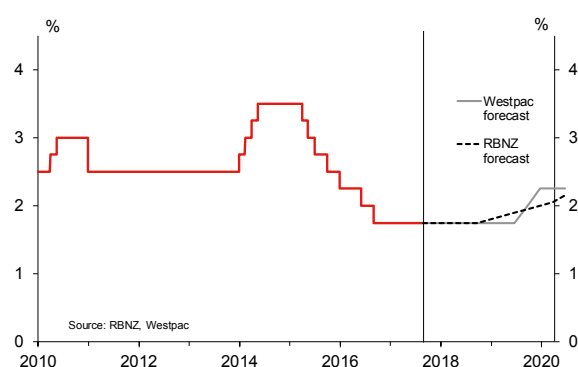
Correspondingly, the RBNZ has repeatedly published a flat forecast for the OCR, with OCR hikes in the picture only from 2019.

However, in recent times New Zealand’s economic landscape has been changing. The construction sector seemed to stall for much of this year; GDP growth has been below expectations; businesses’ confidence in their trading outlook has fallen; the house price boom came to a halt; and consumer spending has flat lined since April. To date the RBNZ has been running with very upbeat forecasts for economic growth and house prices into 2018, but this needs to change. The RBNZ will run with lower near-term GDP and house price forecasts in next week’s *Monetary Policy Statement*.

On the other side of the ledger, inflation was higher than expected in the September quarter, and December is also shaping up as a high inflation quarter. But this has been almost entirely due to transitory factors such as petrol prices. It does not affect the deeper fact that underlying inflation is below the RBNZ’s 2% forecast. Similarly, unemployment has been falling, but that is a lagging indicator. The outlook for the coming year still suggests that the RBNZ must keep interest rates low if it wants inflation to reach 2% on a sustained basis.

At the time of the September OCR Review, the RBNZ hinted that it was going to lower its GDP forecast. It said GDP growth was going to “maintain its current pace” rather than the previous phrase that growth would “improve”. At the time, we argued that this could be a prelude to a more dovish tone in the November MPS. However, there was always an important caveat to that – we said “The remaining determinant of the overall tone in November will be the exchange rate. If it falls by enough to provide some prospective stimulus to inflation, the RBNZ would be able to leave its OCR guidance unchanged.”

RBNZ Official Cash Rate forecasts



That is exactly what has happened. The exchange rate has fallen sharply and unexpectedly in recent weeks, mainly due to the election outcome. The Trade Weighted Index is now 6% lower than the RBNZ forecast in the August MPS. This will provide some much-needed stimulus to the RBNZ's inflation forecast, and will allow the RBNZ to run with the same OCR forecast as previously.

We now expect that the RBNZ will repeat the same guidance paragraph and issue the same flat OCR forecast as in recent Monetary Policy Statements.

The other reason to expect a “straight bat” from the RBNZ at next week’s Monetary Policy Statement is that the election result has made the economic outlook so much more uncertain. The new Government is intent on change, and is prioritising its housing policies. This will have a difficult-to-determine negative impact on house prices over 2018. The Reserve Bank needs to reduce its house price forecast, which in turn will affect its consumer spending forecast. But it won’t know where to pitch these forecasts until it hears more policy specifics. The Government plans to cancel next year’s tax cuts, but to spend more over time – it won’t be easy to anticipate the net impact on inflation until the exact policies are published. And so on and so forth. At this stage, the Reserve Bank is better off waiting and seeing what happens with Government policy, rather than reacting prematurely to policy changes that may or may not eventuate.

We do not expect the mooted changes to the Reserve Bank Act to make much difference to next week’s OCR decision – the Acting Governor will be operating under current law for his entire six-month term, and is legally obliged to heed the current Policy Targets Agreement.

Apart from the unchanged OCR forecast and policy guidance paragraph, the key features of the MPS that we expect are:

- Reference to the improving world economy and rising global equity prices.
- Acknowledgement that the lower exchange rate, if sustained, will help to increase tradables inflation and deliver more balanced growth (previously, “A lower NZD **would** help...”).
- Acknowledgement that the GDP outlook is weaker than in previous forecasts, partly due to less growth in construction than anticipated.
- Acknowledgement that house prices are lower than previously anticipated, although the outlook remains uncertain.
- The RBNZ may water down or remove its warning that headline inflation will fall next year, since the lower exchange rate makes that less certain. However, we expect a repeat of the key sentence that “Non tradables inflation remains moderate but is expected to increase gradually ... ,bringing headline inflation to the midpoint of the target range over the medium term.”
- There would be very little financial market reaction to an MPS along the lines we propose.

Dominick Stephens
Chief Economist

Contact the Westpac economics team

Dominick Stephens, Chief Economist +64 9 336 5671

Michael Gordon, Senior Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Shyamal Maharaj, Economist +64 9 336 5669

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: economics@westpac.co.nz

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