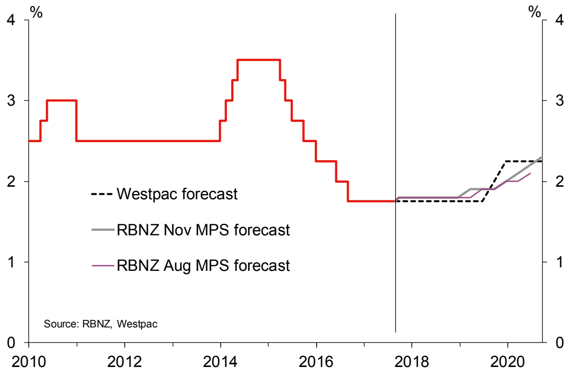
# Glass half full

## Review of the November 2017 Monetary Policy Statement

**9 November 2017**

- As expected, the RBNZ left the OCR unchanged and repeated its neutral guidance for the OCR outlook.
- The RBNZ acknowledged the weak housing market, surprisingly slow construction activity, and weak economic activity data of late.
- But these downsides were offset by the lower exchange rate and the outlook for significant fiscal stimulus.
- In our view, the RBNZ's GDP forecasts are far too optimistic. The RBNZ is forecasting 3.6% annual GDP growth in 2018, whereas we expect 2.5%.
- If our GDP view is correct, the RBNZ will become more dovish in 2018.
- We remain very comfortable forecasting no hike in the OCR until late 2019.

**Official Cash Rate forecasts**




Today's Monetary Policy Statement was very much in line with expectations. The OCR was left unchanged at 1.75%, and the OCR guidance paragraph was the same as has been used, 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."*

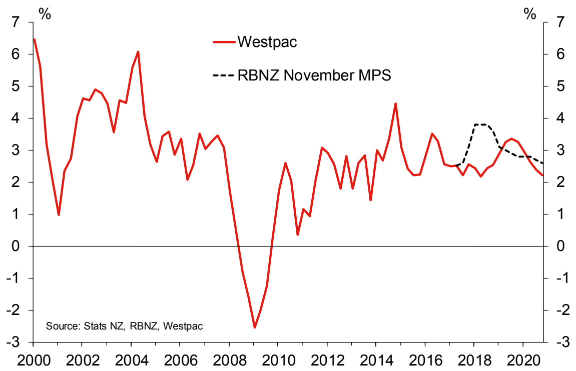
The RBNZ's OCR forecast was the tiniest touch higher than in the August MPS. Rounded to one decimal place, the RBNZ's latest forecast was the same as August in most quarters, but slightly higher in other quarters. This implies that the RBNZ has upgraded its unrounded OCR forecast by, perhaps, three or four basis points. That was presumably a deliberate signal, but in our view it is far too small to constitute a change to the RBNZ's stance. The RBNZ can still be characterised as firmly on hold, as it has been for some time now.

Adding to the overall balanced tone of the MPS, the RBNZ published two alternative scenarios, one positive and one negative. In the negative scenario the OCR falls 100 basis points, and in the positive it rises 100bps. The RBNZ is reminding us that a lot can happen in the economy, and there remain big uncertainties on either side for the OCR outlook.

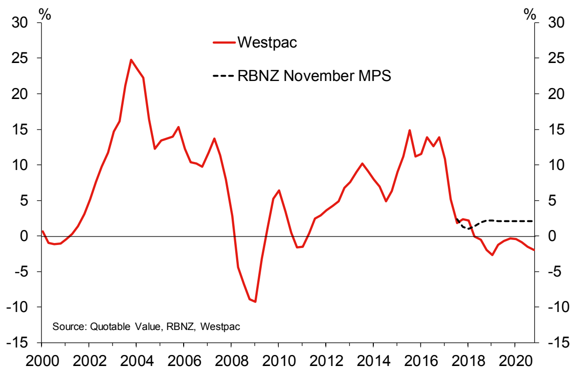
While the overall tone of the MPS was both neutral and much the same as previous missives, there were significant changes beneath the surface. The RBNZ acknowledged that the housing market and construction activity were weaker than previously anticipated, and has downgraded its forecasts in both areas. This downgrade was overdue – we had complained that the RBNZ was too optimistic on construction and house prices in the August MPS. But offsetting these downside developments, the RBNZ acknowledged that the lower exchange rate will support inflation, and it put a lot of weight on the new Government's plan to stimulate the economy by spending more.

The standout for us was the RBNZ's extraordinary optimism about future GDP growth. The RBNZ estimates that the economy grew 0.7% in the September quarter of 2017, whereas our estimate is 0.4%. The RBNZ goes on to forecast that GDP growth will be 0.9% in December 2017, rising to 1.2% in March 2018. That would make March the strongest quarter of GDP growth since March 2014. These are heroic forecasts, to say the least. In recent times we have seen business confidence dropping away, the housing market slow, construction activity slow, and spending on electronic card transactions has been virtually flat. With the uncertainty associated with a change of Government lying ahead of us, population growth slowing sharply, and the reality of a slow housing market sinking in, we find it highly unlikely that the economy will reach these heights. Our own forecast for GDP growth in March 2018 is 0.5%.

**GDP growth forecasts**




**House price growth forecasts**




Turning to the longer run forecasts, the RBNZ is basing its outlook on a number of assumptions that also seem optimistic to us. The RBNZ is assuming 2% per annum house price inflation in the coming years, whereas we would expect house prices to fall given the Government's tax and regulatory plans. The RBNZ assumes that low house price inflation will have little impact on consumer spending, whereas we view the recent slowdown in card transactions as evidence that the housing wealth effect is alive and kicking. The RBNZ expects that oil prices and New Zealand export commodity prices will remain unchanged over 2018, whereas we expect both to fall due to slower economic growth in China next year (indeed, dairy auction prices have already fallen below the RBNZ's assumed level).

Our view is that the RBNZ will be disappointed by the state of GDP growth over 2018, and surprised by the weakness of the housing market. This would cause the RBNZ to lower its medium term inflation outlook. Under these conditions the exchange rate would probably fall, providing some offset for the RBNZ. But overall, we expect that the RBNZ will have to become more dovish over the course of 2018. We remain very comfortable forecasting no hike in the OCR until late 2019.

An important aspect of the MPS was the RBNZ's preliminary assessment of how the new Government's policies will affect the economy. The RBNZ's assessment was that the Government's policies would lean firmly in the direction of a higher OCR than otherwise. This was enough to counterbalance the run of weak actual data seen recently, allowing the RBNZ to leave the OCR forecast broadly unchanged. The RBNZ's key assumptions, and our assessment of them, were:

- The plan to boost Government expenditure will put upward pressure on inflation and the OCR, even allowing for some crowding out of private sector activity. We agree.
- The rising minimum wage will produce a small boost to inflation. We agree.
- Kiwibuild will only partly displace private sector construction activity. There will be a net increase in construction activity, putting upward pressure on the OCR. We disagree. In our view, Kiwibuild will mostly displace private sector construction activity that would otherwise have taken place.
- The RBNZ appears to have made no allowance for the free tertiary education plans, which will directly reduce inflation.
- The RBNZ appears not to have made much allowance for the Government's plan to ban foreign buyers of houses and change the tax treatment of property investors – they are still forecasting house price increases, whereas we expect these policies to result in modest house price declines.

## Macroprudential policy

During the post-MPS press conference, the RBNZ Governor stated that they were reviewing the criteria under which the LVR mortgage lending restrictions may be loosened, and will say more at the November 29 Financial Stability Review. We are not expecting any change to the LVRs in the near term, but we do acknowledge this as a risk to our forecasts. If the RBNZ does loosen the LVR restrictions there could be a positive response on house prices. That said, we doubt that the impact would be large – the RBNZ has repeatedly stated that it would loosen the LVR restrictions only gradually, and in any case mortgage rates and tax policy will probably have a larger effect on house prices than macroprudential policy.

## Uncertainties ahead

While monetary policy seems steady at present, there are many moving parts that could push things in either direction. We have highlighted that the RBNZ's GDP forecasts are too optimistic, and that this could push the

RBNZ in a dovish direction over 2018. Another uncertainty is how the Government's plan to give the RBNZ a dual mandate will affect OCR decisions. But perhaps most important is the identity of the new Governor, which may be announced before Christmas. Markets should remain very alert to the chance of a shift in direction in New Zealand monetary policy.

**Dominick Stephens**
Chief Economist

## Side by side of the September OCR review and the November *Monetary Policy Statement* - key changes highlighted

| **Official Cash Rate unchanged at 1.75 percent**<br>**September OCR Review, 28 September 2017** | **Official Cash Rate unchanged at 1.75 percent**<br>**November Monetary Policy Statement, 9 November 2017** |
|---|---|
| The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 1.75 percent. | The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 1.75 percent. |
| Global economic growth has continued to improve in recent quarters. However, inflation and wage outcomes remain subdued across the advanced economies and challenges remain with on-going surplus capacity. Bond yields are low, credit spreads have narrowed and equity prices are near record levels. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward. | Global economic growth continues to improve, although inflation and wage outcomes remain subdued. Commodity prices are relatively stable. Bond yields and credit spreads remain low and equity prices are near record levels. Monetary policy remains easy in the advanced economies but is gradually becoming less stimulatory. |
| The trade-weighted exchange rate has eased slightly since the August Statement. A lower New Zealand dollar would help to increase tradables inflation and deliver more balanced growth. | The exchange rate has eased since the August Statement and, if sustained, will increase tradables inflation and promote more balanced growth. |
| GDP in the June quarter grew in line with expectations, following relative weakness in the previous two quarters. While exports recovered, construction was weaker than expected. Growth is projected to maintain its current pace going forward, supported by accommodative monetary policy, population growth, elevated terms of trade, and fiscal stimulus. | GDP in the June quarter grew broadly in line with expectations, following relative weakness in the previous two quarters. Employment growth has been strong and GDP growth is projected to strengthen, with a weaker outlook for housing and construction offset by accommodative monetary policy, the continued high terms of trade, and increased fiscal stimulus. |
| | The Bank has incorporated preliminary estimates of the impact of new government policies in four areas: new government spending; the KiwiBuild programme; tighter visa requirements; and increases in the minimum wage. The impact of these policies remains very uncertain. |
| House price inflation continues to moderate due to loan-to-value ratio restrictions, affordability constraints, and a tightening in credit conditions. This moderation is expected to continue, although there remains a risk of resurgence in prices given population growth and resource constraints in the construction sector. | House price inflation has moderated due to loan-to-value ratio restrictions, affordability constraints, reduced foreign demand, and a tightening in credit conditions. Low house price inflation is expected to continue, reinforced by new government policies on housing. |
| Annual CPI inflation eased in the June quarter, but remains within the target range. Headline inflation is likely to decline in coming quarters, reflecting volatility in tradables inflation. Non-tradables inflation remains moderate but is expected to increase gradually as capacity pressure increases, bringing headline inflation to the midpoint of the target range over the medium term. Longer-term inflation expectations remain well anchored at around two percent. | Annual CPI inflation was 1.9 percent in September although underlying inflation remains subdued. Non-tradables inflation is moderate but expected to increase gradually as capacity pressures increase. Tradables inflation has increased due to the lower New Zealand dollar and higher oil prices, but is expected to soften in line with projected low global inflation. Overall, CPI inflation is projected to remain near the midpoint of the target range and longer-term inflation expectations are well anchored at 2 percent. |
| Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly. | Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly. |

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