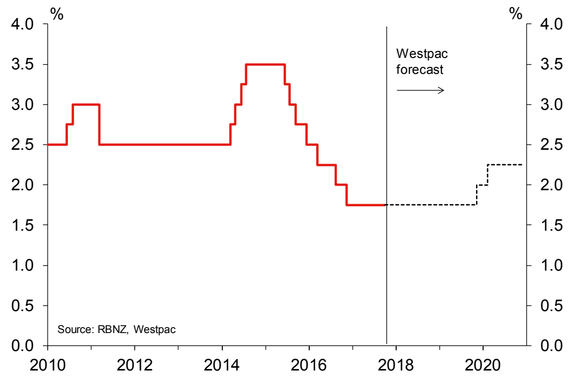
Tin Whistle

Preview of RBNZ OCR Review, 28 September 2017

22 September 2017

- The RBNZ is highly unlikely to alter the stance of monetary policy next week, due to election uncertainty.
- Fortunately, the economic situation is such that the RBNZ can afford to sit on its hands.
- We expect no change in the OCR next week, and a repeat of previous monetary policy guidance.
- Beneath this placid surface, there is a lot going on with monetary policy.
- In time, we expect the RBNZ will have to reduce its GDP and house price forecasts, which will affect the stance of monetary policy.

Westpac OCR forecast



On next week's news wires, the Reserve Bank's *Monetary Policy Statement* will be like a tin whistle next to the foghorn of election-related news, but it is still something financial markets need to watch.

By Thursday next week, when the OCR Review will be published, we may still be waiting to hear the official election result. We may not yet know what the governing coalition will be. And even if we do know the makeup of Government, we will not know exactly what the policy platform is likely to look like. Faced with such uncertainties, the RBNZ would be ill advised to commit itself to any new course for monetary policy. Fortunately, the economic situation is such that the RBNZ probably can afford to sit on its hands for now.

The RBNZ has run a very consistent line on monetary policy over the past six months, and it seems highly likely that it will play a straight bat again next week. We firmly expect that the final paragraph of the one-page press release will be a repeat of the phrases that have been used more-or-less unchanged for the past five missives:

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

Just because the RBNZ is likely to play it safe on this occasion, doesn't mean that monetary policy has gone stale. On the contrary, there is a quite a lot going on beneath the surface. Since the RBNZ published its August *Monetary Policy Statement* there have been four key developments, which will need to be acknowledged in the body of the RBNZ's press release:

- The global economy has strengthened further and the US Federal Reserve has edged closer to tightening monetary policy.
- The Trade Weighted Index is averaging about 1.5% lower than the RBNZ's forecast.
- Construction activity has turned out weaker than the RBNZ was expecting. GDP figures show that construction activity fell 3.2% over the first half of 2017, and recent dwelling consent numbers have been weak.
- The housing market has turned out much weaker than the RBNZ was forecasting. In the August MPS, the RBNZ forecast that house prices would rise 3.2% over the six

months to September 2017. The latest data suggest that house prices have instead fallen by 1.5%.

In our view, the weak housing market and stalled construction sector are important developments. Both are likely to be the product of tightening financial conditions – people are finding it harder to get loans, and mortgage rates are higher than they were. This situation is not going to change any time soon, so we expect that the housing market is set to stay subdued, and that construction activity will expand more slowly than we had previously forecast. In acknowledgement of these developments, we have been reducing our GDP forecasts for the coming year.

By contrast, the Reserve Bank is forecasting a rapid recovery in construction activity, and has consistently said that there is a risk of a resurgence in house prices.

To date, the evidence has probably been insufficient for the Reserve Bank to change its view – hence the likelihood that the Reserve Bank's stance on monetary policy won't be altered next week.

But in time, if our views on construction and housing prove correct, the Reserve Bank will have to lower its GDP and house price forecasts. The overall stance of monetary policy would then hinge on what happens to the exchange rate. If the TWI continues to trend downwards, as we expect, then the RBNZ would continue to forecast no change in the OCR. But if the exchange rate failed to fall, the RBNZ might have to adopt an easing bias.

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