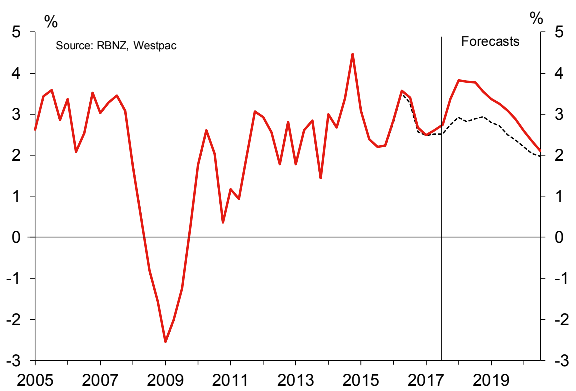
Subtle changes

Review of the September 2017 OCR decision

28 September 2017

- The RBNZ left its bottom-line guidance for monetary policy unchanged.
- The most important change was an apparent downgrade to the RBNZ's GDP forecast, due to the stalled construction sector.
- However, the lower exchange rate and stronger global economy were also acknowledged, at least partly counterbalancing lower GDP growth.
- The RBNZ did not acknowledge the fact that house prices have been much weaker than its previous forecast, presumably because it is wary of a post-election market resurgence.
- In our view, the weak housing market and stalled construction sector will cause the RBNZ to strike a more dovish tone at the November MPS, unless the exchange rate falls sharply.
- We remain firmly of the view that market pricing for an OCR hike in 2018 is far too early. We forecast the OCR to remain unchanged until late-2019, with evenly balanced risks to that flat forecast.

GDP forecasts (annual)



The RBNZ left the OCR unchanged at 1.75% at this morning's OCR Review, and repeated the bottom line guidance that has been used more-or-less unchanged all year: *"Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly."*

This is exactly what we were expecting – the post-election environment is simply too uncertain for the RBNZ to strike any bold new tone, and the economic situation does afford the central bank time to sit on its hands for now.

The interest in this OCR Review was always going to be in the detail. The most important development was a downgrade to the RBNZ's growth outlook. The RBNZ acknowledged that construction activity has been "weaker than expected", and said that "Growth is projected to maintain its current pace going forward." This is clearly weaker than the RBNZ's previous statement that "Growth is expected to improve going forward." If the most recent quarterly GDP outturn was repeated, the annual percentage change in GDP would reach 3.2% by June 2018. That compares to the RBNZ's forecast of 3.8% that appeared in the August MPS. This stands to reason – we have also been downgrading our GDP forecasts due to surprisingly weak construction activity.

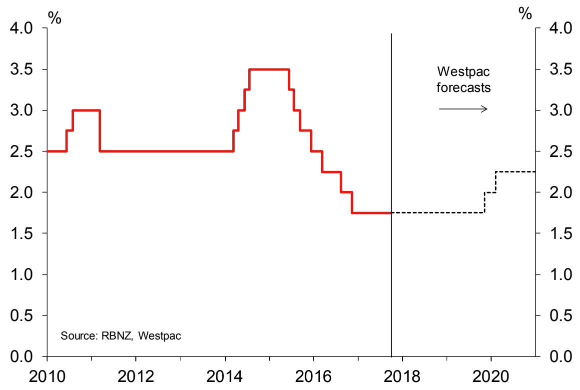
There was also a veiled acknowledgement of the recent slowdown in net migration. The RBNZ dropped the word "strong" from its descriptions of population growth.

Counterbalancing the weaker domestic growth outlook, the RBNZ acknowledged the strength of global growth, which was described as having "improved" in recent quarters. That was a slight upgrade on the August description that global growth was becoming "more broad-based." And the RBNZ acknowledged that the exchange rate had fallen by more than anticipated. The RBNZ said that a lower NZ dollar "would help". This represents a slight downgrade to the RBNZ's level of consternation about the high exchange rate compared to August, when the RBNZ said a lower exchange rate "is needed."

The one missing acknowledgement was on house prices. The RBNZ made no changes to its description of the housing market, despite house price growth over the past six months being around 4.7% weaker than its August forecast. This was not surprising – the RBNZ presumably remains wary of the housing market rebounding after the election.

Putting all of this together, we think today's OCR Review hints at the November *Monetary Policy Statement* being more dovish than the August *Monetary Policy Statement*. We can now be fairly sure that the RBNZ will publish a lower GDP forecast. And they will probably also have to downgrade the house price forecast, even if the market is rebounding following the election, given how much lower house prices actually are compared to the previous forecast. Together, these forecast changes would make quite a dent in the RBNZ's medium-term inflation outlook. 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. But if the exchange rate fails to fall by enough, the RBNZ may have to downgrade the OCR outlook.

Official Cash Rate forecast



Dominick Stephens
Chief Economist

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

Official Cash Rate unchanged at 1.75 percent **Monetary Policy Statement, 10 August 2017**	**Official Cash Rate unchanged at 1.75 percent** **September OCR Review, 28 September 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 become more broad-based 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 at record levels. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.	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.
The trade-weighted exchange rate has increased since the May *Statement*, partly in response to a weaker US dollar. A lower New Zealand dollar is needed to increase tradables inflation and help deliver more balanced growth.	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.
GDP in the March quarter was lower than expected, adding to the softening in growth observed at the end of 2016. Growth is expected to improve going forward, supported by accommodative monetary policy, strong population growth, an elevated terms of trade, and the fiscal stimulus outlined in Budget 2017.	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.
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 persist, although there remains a risk of resurgence in prices given continued strong population growth and resource constraints in the construction sector.	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.
Annual CPI inflation eased in the June quarter, but remains within the target range. Headline inflation is likely to decline in coming quarters as the effects of higher fuel and food prices dissipate. The outlook for tradables inflation remains weak. 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 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.
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.

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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