Weekly Commentary

20 November 2017

Brave new-ish world for RBNZ

New Zealand's monetary policy framework is approaching its biggest shake up in thirty years. The new Government plans to expand the RBNZ's mandate to include a focus on maximising employment as well as price stability. This raises questions about how the RBNZ will balance these goals, and what it might mean for interest rates and inflation.

For nearly 30 years now, New Zealand monetary policy has been squarely focused on ensuring price stability. What this has meant precisely in terms of inflation target has been tweaked a little over time. In addition, successive updates to the Policy Targets Agreement (PTA) have directed the RBNZ to also consider factors such as asset prices and volatility in the exchange rate in its pursuit of price stability. But despite such changes, the core of the monetary policy framework has essentially remained intact since its inception.

However, over the coming months we're likely to see a large shake-up in the framework. The Labour-led coalition Government has signalled that it intends to expand the RBNZ's mandate to include a focus on maximising employment as well as price stability. There's also likely to be a change in the decision making structure at the RBNZ, with a shift away from the current single decision maker model to a committee structure.

With regards to the decision making structure, the proposed shift to a committee doesn't imply a big change to how the RBNZ sets policy. The RBNZ already uses a committee structure for some of its internal policy deliberations, and it includes a number of external advisers. Importantly, this change on its own doesn't imply a shift in the RBNZ's thinking with regards to the balance between activity and inflation.

In contrast, the shift to a dual mandate could have larger implications for the stance of policy. Recent media comments from the Minister of Finance indicate that the Government wants the RBNZ to place more emphasis on the state of the labour market than it has in the past. In addition, a new Governor will step into the ring in March, and the Finance Minister has signalled that he favours the appointment of someone who will follow the spirit of the coming changes to the RBNZ's mandate (the actual selection of Governors is made by the RBNZ's Board, but must be approved by the Minister).

The key question is whether adding the goal of 'maximising employment' will materially affect the RBNZ's behaviour? Not necessarily. The RBNZ has always been conscious of how its decisions will affect the real economy, including the potential impacts on the labour market and unemployment. In addition, the Government has indicated that it will not set a numerical target for 'maximum employment', or direct the RBNZ how to act when the two goals appear to conflict. Such a specification, along the lines of the dual mandates of the US Federal Reserve and the Reserve Bank of Australia, might prove to be fairly benign.

However, a key concern with a 'maximum employment' goal is that it's not symmetric. We doubt it would have prompted the RBNZ to act any differently in recent years, when both inflation and unemployment pointed in the direction of keeping interest rates low. But the acid test would come when the economy is running hot and unemployment is below its long-run sustainable rate (which the RBNZ puts

Brave new-ish world for RBNZ cont.

somewhere around 4 to 5%). Keeping inflation on target at these sorts of times would argue for higher interest rates. That would cause a rise in unemployment, putting the two goals in conflict.

If the employment mandate caused the RBNZ to become quicker to cut interest rates and slower to raise them, the consequence would be higher inflation over time. That could actually be detrimental for growth over an extended period. It is possible for monetary policy to generate temporary increases in employment growth. However, it's not possible to run loose monetary policy indefinitely to boost employment growth or keep the unemployment rate artificially low. Attempting to do so ultimately just leads to higher inflation, but not higher employment, as the resulting increases in costs gradually erode the strength of economic activity. That's essentially what we saw around the globe over the 1960s and 1970s.

International and domestic experience has shown that the biggest contribution that monetary policy can make to the economic landscape is ensuring stability in prices. This helps to avoid large swings - up or down - in activity. And over time, this helps to support ongoing, sustainable gains in employment. This is the approach that has been in use in New Zealand for some time.

Housing conditions to remain subdued for an extended period

On the New Zealand data front, the main news over the past week was the release of the REINZ house sales figures for October. Recent weeks have seen some easing in mortgage rates, which has given the housing market a bit of a boost. We've seen this most clearly in Auckland, where house prices have been creeping higher again after moderating in the early part of the year. And we could see this continue for while a while yet,

But despite the recent pick up, New Zealand's housing market is still looking a lot softer than it did this time last year. Sales are down 15% since last October. At the same time, the double digit house price growth we saw in previous years has given way to a period of quite subdued gains. A range of factors has contributed to this slowdown. This includes the creep higher in mortgage rates in late 2016 and early 2017, as well as the tightening in lending restrictions by the RBNZ. Pre-election uncertainty also appears to have had a dampening impact.

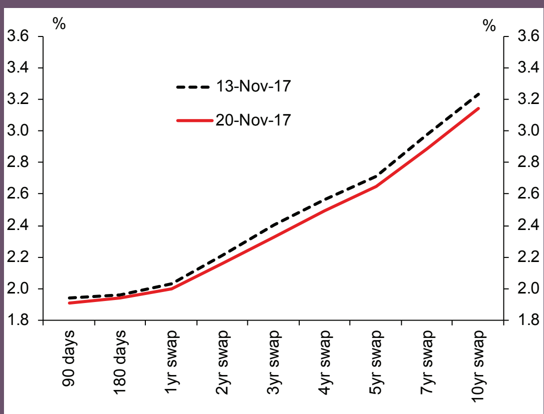
We think the New Zealand economy is in for an extended period of weak house price inflation. The new Government is planning on rolling out a suite of regulatory changes over the coming years that will dampen housing market conditions. First off the block will be a ban on non-resident buyers of existing properties. The 'bright line' test for taxing capital gains on investment properties will also be extended from a two-year minimum holding period to five years. Such changes will be reinforced by tighter migration settings that will reduce the rate of growth in demand for housing. Longer-term, the new government has signalled that it will also remove negative gearing (the ability to use losses on rental properties to offset taxable income from elsewhere). Finally, the Government plans to review New Zealand's tax base, which could see further changes to the tax treatment of capital gains from housing.

Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter terms. Three-to-five-year rates seem high relative to where we think short-term rates are going to go over that time. Some lending and deposit rates have been falling recently, so it may be worth waiting to see if there are further modest reductions in fixed-term rates.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates



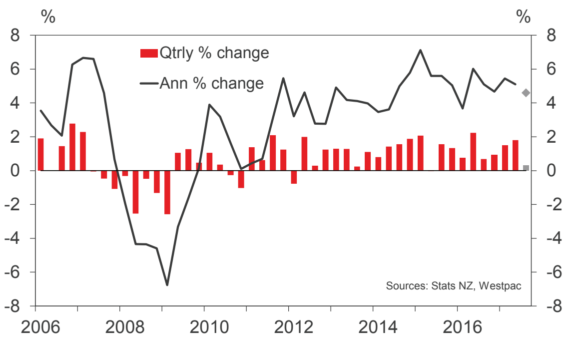
The week ahead

NZ Q3 real retail sales

Nov 23, Last: +1.7%, Westpac f/c: +0.3%, Mkt f/c: 0.1%

- Retail spending powered ahead in the June quarter, boosted by some high profile sporting events - the World Masters Games and the Lions rugby tour. These events, and the associated strength in tourism inflows, saw strong spending in the hospitality sector. The June quarter also saw spending gains in areas such as building supplies and electronics.
- As we've moved into the second half of the year, the momentum in retail spending appears to have faded. A key reason for this is the slowdown in the housing market, which has dampened spending on durable items like household furnishing. We expect only a 0.3% gain in retail volumes in the September quarter. That would be the slowest growth we've seen since 2015.

Real retail sales

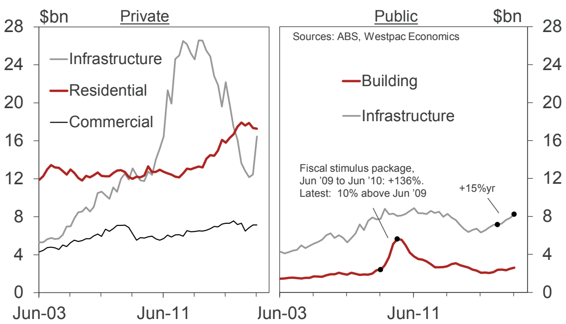


Aus Q3 construction work

Nov 22, Last: 9.3%, WBC f/c: –2.7%
Mkt f/c: -2.3%, Range: –7.5% to 24.0%

- Currently, the Construction Work survey is an unreliable partial indicator for the National Accounts. Recently, LNG platforms have been imported. The survey includes the full value of the platform when it is imported, rather than actual work in the period, as in the national accounts. In Q2, 'construction work' reportedly spiked, +9.3%, boosted by imported platforms (which is included in private infrastructure). For Q3, with fewer platforms imported (1 rather than 2), we expect a partial reversal, -2.7%. We caution, there is a high degree of uncertainty around this forecast - the value of these platforms is unclear, due to commercial in confidence. Turning to private building and public works, activity in these areas grew by 1.2% in Q2 and we anticipate a further 1.5% increase in Q3, with broad based strength, across residential, commercial building and public construction.

Construction work: divergent trends

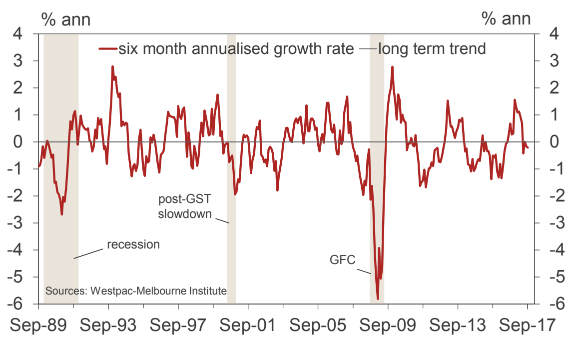


Aus Oct Westpac–MI Leading Index

Nov 22, Last: –0.2%

- The Leading Index has swung sharply in recent months from well above trend to back below trend, the six month annualised growth rate holding at 0.2% below trend in Sep. The turnaround mainly reflects swings in Australia's commodity prices and to a lesser extent a shift to a rising yield curve implying tightening financial conditions.
- The Oct read will include updates on the ASX200 which surged strongly, up 4%. Other components have been mixed. On the negative side, consumer sentiment based measures deteriorated slightly and commodity prices were down 0.9% in AUD terms. On the plus side, dwelling approvals rose 1.8%; the yield spread widened slightly; and total hours worked continued to tick over. The six month growth rate may pick up given earlier weakness is starting to drop out of the picture.

Westpac-MI Leading Index



Data calendar

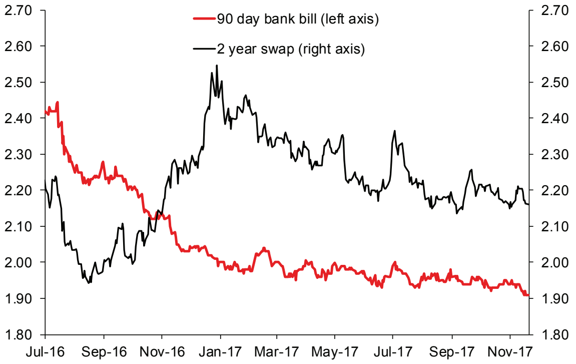
		Last	Market median	Westpac forecast	Risk/Comment
Mon 20					
NZ	Oct Performance of Services Index	56.0	–	–	Momentum in services has been easing in recent months.
	Oct food prices	–0.2%	–	–0.6%	Seasonal drop in produce prices; annual inflation picked up.
Aus	RBA speak	–	–	–	Kearns & Kohler speak in Sydney.
Eur	ECB President Draghi speaks	–	–	–	Draghi at ECON hearing at European parliament in Brussels.
US	Oct leading index	–0.2%	0.6%	–	Points to at-trend growth.
Tue 21					
Aus	RBA minutes	–	–	–	Further detail around the SoMP forecast update.
	RBA Governor Lowe speaking	–	–	–	ABE annual dinner, Sydney 8.05 pm, topic TBA, media Q&A.
UK	Oct public set net borrowing, £b	5.3	–	–	Spending reductions and higher tax take curbed borrowing.
US	Oct Chicago Fed activity index	0.17	–	–	Robust growth continuing.
	Oct existing home sales	0.7%	0.2%	–	Trend has flattened.
	Fed chair Yellen speaks	–	–	–	At NYU's Stern business school.
Wed 22					
NZ	GlobalDairyTrade auction	-3.5%	–	–	Dairy prices to continue to soften as demand wavers.
	Oct net migration	5190	–	5200	Monthly migration peak has passed, with departures rising.
Aus	Oct Westpac–MI Leading Index	–0.2%	–	–	6mth pace may start to lift as earlier weakness drops out.
	Q3 construction work done	9.3%	–2.3%	–2.7%	Survey distorted as LNG platforms imported.
UK	UK Budget	–	–	–	Pressure to spend, but softer growth outlook a constraint.
Eur	Nov consumer confidence prelim.	–1	–1.0	–	Very positive.
US	Initial jobless claims	249k	–	–	A day ahead of schedule given Thanksgiving on Thursday.
	Oct durable goods orders prelim.	2.0%	0.3%	–	Investment has fared better in 2017; but growth modest.
	Nov Uni. of Michigan sentiment	97.8	98.2	–	Remains above long-run average.
	FOMC minutes	–	–	–	Discussion from the November meeting.
Thu 23					
NZ	Q3 retail sales (excl. inflation)	1.9%	0.1%	0.3%	Slowdown in the housing market dampening spending.
Eur	Nov Markit manufacturing PMI flash	58.5	58.2	–	Total new orders rose in Oct despite softer o/s orders.
	Nov Markit services PMI flash	55.0	55.2	–	Now 51 months above 50 expansion/ contraction threshold.
	ECB minutes	–	–	–	Account of October policy meeting.
UK	Q3 GDP (provisional)	0.4%	–	0.4%	Sluggish domestic demand continues to dampen growth.
US	Thanksgiving	–	–	–	Public holiday.
Fri 24					
NZ	Oct trade balance, $m	–1143	–760	–600	Expecting a moderation in exports after a September surge.
US	Nov Markit manufacturing PMI flash	54.6	55.0	–	Less positive than ISM surveys…
	Nov Markit services PMI flash	55.3	–	–	… but still pointing to robust growth across economy.

New Zealand forecasts

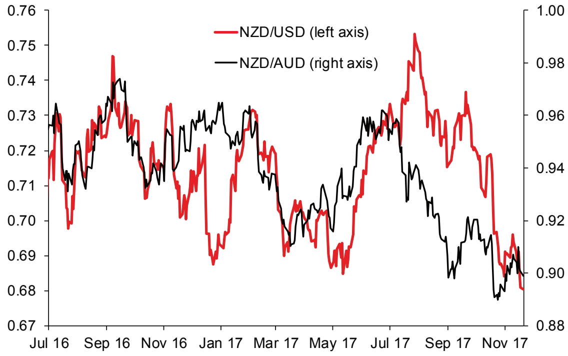
Economic Forecasts	2017				Calendar years			
% change	Jun	Sep	Dec	Mar	2015	2016	2017f	2018f
GDP (Production) ann avg	0.8	0.4	0.7	0.5	2.5	3.0	2.4	2.4
Employment	-0.1	2.2	-0.2	0.6	1.4	5.8	3.1	1.6
Unemployment Rate % s.a.	4.8	4.6	4.5	4.5	5.0	5.3	4.5	4.7
CPI	0.0	0.5	0.6	0.3	0.1	1.3	2.1	1.4
Current Account Balance % of GDP	-2.8	-2.4	-2.3	-1.9	-3.2	-2.5	-2.3	-2.5

Financial Forecasts	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	1.95	1.95	1.95	1.95	1.95	1.95
2 Year Swap	2.10	2.10	2.20	2.30	2.40	2.50
5 Year Swap	2.60	2.70	2.80	2.95	3.10	3.20
10 Year Bond	2.95	3.10	3.20	3.35	3.40	3.45
NZD/USD	0.68	0.67	0.66	0.64	0.63	0.63
NZD/AUD	0.89	0.89	0.89	0.89	0.90	0.91
NZD/JPY	77.5	76.4	75.9	74.5	73.1	73.7
NZD/EUR	0.59	0.58	0.58	0.57	0.56	0.57
NZD/GBP	0.52	0.51	0.51	0.51	0.50	0.50
TWI	72.6	71.8	71.2	69.9	69.2	69.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 20 November 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.76%	1.78%	1.81%
60 Days	1.83%	1.86%	1.87%
90 Days	1.91%	1.94%	1.94%
2 Year Swap	2.16%	2.16%	2.18%
5 Year Swap	2.65%	2.61%	2.68%

NZ foreign currency mid-rates as at 20 November 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6804	0.6912	0.6965
NZD/EUR	0.5774	0.5949	0.5927
NZD/GBP	0.5152	0.5286	0.5277
NZD/JPY	76.31	78.83	79.00
NZD/AUD	0.8989	0.9028	0.8922
TWI	72.33	73.60	73.76

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017f	2018f	2019f
Australia						
Real GDP % yr	2.8	2.4	2.5	2.5	3.0	2.5
CPI inflation % annual	1.7	1.7	1.5	1.7	2.0	2.0
Unemployment %	6.2	5.8	5.7	5.5	6.1	6.0
Current Account % GDP	-3.0	-4.7	-2.7	-1.6	-2.2	-2.6
United States						
Real GDP %yr	2.6	2.9	1.5	2.2	2.1	2.0
Consumer Prices %yr	1.6	0.1	1.3	2.0	1.8	1.8
Unemployment Rate %	6.2	5.3	4.9	4.4	4.1	4.1
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	0.3	1.1	1.0	1.3	1.1	0.9
Euroland						
Real GDP %yr	1.3	2.0	1.8	2.2	1.8	1.7
United Kingdom						
Real GDP %yr	3.1	2.2	1.8	1.6	1.6	1.5
China						
Real GDP %yr	7.3	6.9	6.7	6.8	6.2	5.9
East Asia ex China						
Real GDP %yr	4.2	3.8	3.9	4.1	4.1	4.2
World						
Real GDP %yr	3.6	3.4	3.2	3.7	3.6	3.6
Forecasts finalised 10 November 2017						

Interest Rate Forecasts	Latest	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.72	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.58	2.65	2.85	2.85	2.95	3.00	3.00	3.00
International								
Fed Funds	1.125	1.375	1.375	1.625	1.625	1.875	1.875	1.875
US 10 Year Bond	2.35	2.40	2.60	2.75	2.90	3.00	3.00	3.00
ECB Deposit Rate	−0.40	−0.40	−0.40	−0.40	−0.40	−0.40	−0.30	−0.30

Exchange Rate Forecasts	Latest	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
AUD/USD	0.7601	0.76	0.75	0.74	0.72	0.70	0.69	0.68
USD/JPY	112.47	114	114	115	116	116	117	118
EUR/USD	1.1815	1.15	1.15	1.14	1.13	1.12	1.11	1.10
AUD/NZD	1.1055	1.12	1.12	1.12	1.12	1.11	1.10	1.08

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