# Mixed messages

## Preview of RBNZ Monetary Policy Statement, 9 Aug 2018

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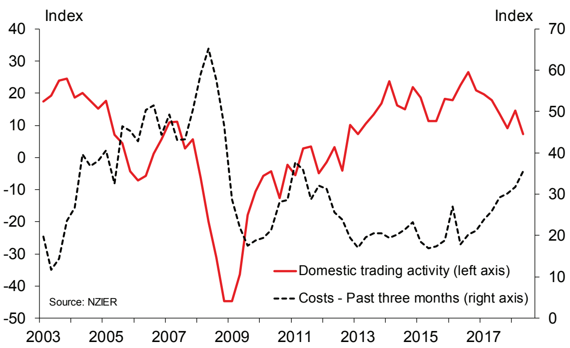
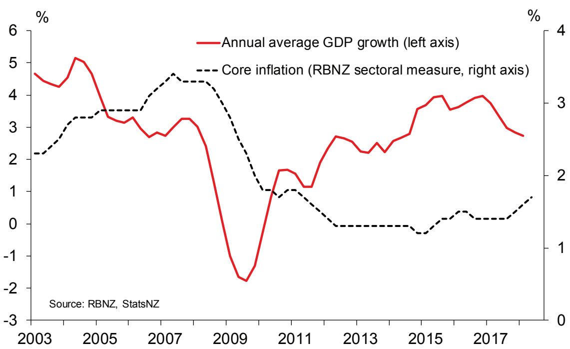
- At next week's *Monetary Policy Statement*, the RBNZ will probably repeat that it expects to keep the OCR at its current low level for a long while.
- We also expect the RBNZ to restate that the next move in the OCR could be "up or down".
- The OCR forecast will likely be unchanged, or perhaps could be shifted a tiny smidgen lower.
- The economy has delivered mixed messages recently, with growth slowing but inflation pressures rising. These forces will broadly offset one another in the RBNZ's thinking.
- Like us, markets are primed for a neutral to slightly dovish *Statement*.

**Slowing activity and rising inflation: measures from the Quarterly Survey of Business Opinion**




**Slowing activity and rising inflation: official measures**




Next week the Reserve Bank will deliver its third monetary policy missive under Governor Adrian Orr. The economy has been sending out contradictory signals for monetary policy, as it so often does – growth is slowing, but inflation is picking up. We expect that these positives and negatives will roughly offset one another in the Reserve Bank's deliberations, meaning that it will stay on roughly the same course as it charted in May.

Back in May the Reserve Bank's main point was that employment is around its sustainable level, but inflation is below target. The balance of those factors meant that the OCR would have to remain at a stimulatory level for a considerable period of time. The RBNZ's forecasts showed an unchanged OCR through until late-2019, and gradual increases thereafter. However, the May *MPS* emphasised more heavily that the OCR could move in either direction if required by changing conditions. Markets interpreted that as surprisingly dovish, and latched on to the RBNZ's comment that the next move in the OCR could be "up or down".

In its short June OCR review, the RBNZ reiterated the main messages from May, and repeated the "up or down" phrase. However, it emphasised recent weaker GDP data and interpreted the Government's recently released Budget as less stimulatory, suggesting it thought that the balance of risks had moved slightly further away from OCR hikes. We were surprised by the RBNZ's interpretation around fiscal policy, particularly given that the Treasury had judged the Budget to be stimulatory for monetary policy.

Next week we expect the RBNZ to once again reiterate its main "on hold" message. We also expect the RBNZ to reuse the words "up or down", given the importance this phrase has attained in the mind of financial markets. The commentary on recent events is likely to be two sided, with both positive and negative developments discussed. That said, next week's document may still feel slightly more dovish than the May *MPS*. We expect the RBNZ's OCR forecast to be the same as in May. However, if there is a change to the OCR forecast, it will likely be very small, and is more likely to be downward than upward.

The main contours of the economic landscape that the Reserve Bank will have to map out in the detail of the *Statement* are:

- **The slowing economy**. For a long while, the Reserve Bank expected that the economy would accelerate over the first half of 2018, whereas we expected it to decelerate. The evidence has now clearly piled up in favour of a deceleration – everything from business confidence to consumer spending has slowed. The Reserve Bank is going to have to trim its growth forecasts, and that will be a powerful argument against OCR hikes.

- **Rising inflation**. The Reserve Bank's goal of 2% sustained inflation now looks more attainable than it has for years: core inflation has risen from 1.5% to 1.7%; non-tradables inflation has exceeded expectations; businesses are reporting rising costs; there are signs of emerging wage pressure; and rising petrol prices will soon cause a short-term spike in inflation to 2%. This counteracts the slowing economy from a monetary policy perspective, and is an argument in favour of OCR hikes.
- **Falling exchange rate**. The exchange rate has remained consistently below the Reserve Bank's May forecast, which will help bolster inflation.
- **Weak housing market**. Although the Reserve Bank did anticipate that the housing market would cool, the slowdown has been more severe than they anticipated. House prices have fallen on a nationwide basis over the past three months.
- **Labour market**. While the unemployment rate ticked up to 4.5% in the June quarter, that was neither here nor there in the scheme of things. The details of the June labour market report showed ongoing strong employment growth and burgeoning wage pressures. The Reserve Bank's previous judgement remains valid – employment is close to its maximum sustainable level and the state of the labour market is a reason not to cut the OCR.
- **Fiscal policy**. We expect that the Reserve Bank will reiterate its interpretation that the Government's May Budget signalled a reduction in fiscal stimulus relative to previous forecasts. Given that the Treasury drew the opposite conclusion, the RBNZ will have to explain itself. That explanation will probably lie in the emphasis the RBNZ puts on KiwiBuild, and perhaps in the timing of fiscal stimulus.
- **Global trade wars**. These have the potential to disrupt an otherwise strong global economy, and will surely rate a mention.

## Market reaction

Swap rates have fallen in recent weeks, and markets are primed for a slightly dovish *MPS*. An *MPS* along the lines we are proposing, with an unchanged or slightly lower OCR track and slightly dovish details in the write-up, would produce very little market reaction. Conversely, markets would react very strongly to a hawkish *Statement*.

There are three features of the *Statement* that markets will focus on:

- If the RBNZ removes the words "up or down" from the *Statement*, markets would regard that as a hawkish signal (unless the phrase was replaced by something obviously more dovish).
- Markets are very focused on the RBNZ's OCR forecast. Anything other than an unchanged or very slightly lower forecast would produce a large market reaction.
- Exchange rate markets would obviously react to any comments aimed directly at the NZ dollar. However, such comments have been conspicuously absent from recent RBNZ communications, and we see no reason for that to change next week.

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