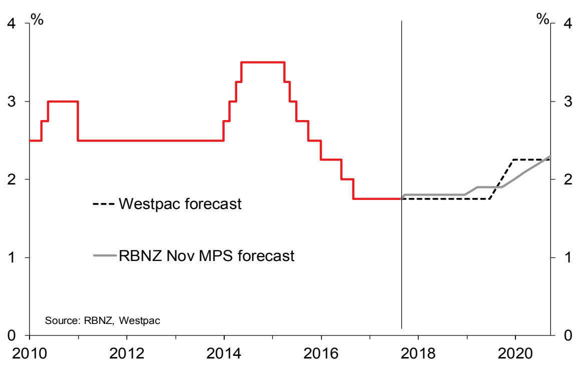
The great moderation

Preview of RBNZ Monetary Policy Statement, 8 February

1 February 2018

- The past year has been one of unprecedented consistency from the RBNZ.
- We expect that consistency to continue next week, with no change to the OCR outlook or policy guidance wording.
- Recent developments have been roughly neutral from the RBNZ's perspective.
- The RBNZ is likely to express its displeasure about the recent rise in the exchange rate, which would elicit a reaction on foreign exchange markets.
- The other key developments the RBNZ will discuss include surprisingly weak inflation and the renewed vigour of the housing market.
- We have long argued that inflation will prove lower than the RBNZ expects, and continue to forecast OCR hikes only from late-2019.

Official Cash Rate forecasts



Last year was an easy one for those of us charged with forecasting the OCR. For the whole year the OCR was kept unchanged. The year's four *Monetary Policy Statements* (MPS) featured almost identical OCR forecasts, which signalled no change in the OCR until mid-2019, and very gradual hikes thereafter. And the key guidance paragraph was more or less the same in every MPS or OCR Review:

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

Of course, there were changes to the detail. In the November MPS, the RBNZ acknowledged that the economy and housing market were slowing by more than they had previously allowed for. However, the RBNZ also pointed out that the newly elected Government planned to run more expansionary fiscal policy, which could restimulate the economy. Bearing these unders and overs in mind, the RBNZ assessed that the inflation outlook was broadly unchanged and issued yet another "firmly on hold" *Monetary Policy Statement*.

We expect next week's February MPS will continue the theme of consistency, with no material change to the RBNZ's OCR forecast, and no change to the policy guidance paragraph. There will, however, be some changes beneath the surface. The RBNZ's press release, and the detail of the *Monetary Policy Statement*, will no doubt allude to the key developments and surprises since November. We count five of these:

Inflation was substantially lower than forecast in December 2017, continuing the recent pattern of downside inflation surprises. This will probably leave inflation below 2% for another year. The RBNZ has been at pains to explain why it isn't acting more vigorously to lift inflation to the 2% target, for example in a recent speech by Governor Grant Spencer. They may feel the need to bring these points to the fore once again.

The exchange rate has risen unexpectedly. Much of this is actually just the flip side of US dollar weakness – the Trade Weighted Index is only 2% higher than the RBNZ anticipated. When the TWI dropped below 73 late last year, the RBNZ dropped its oft-repeated statement that "a lower exchange rate was needed", instead judging the exchange rate to be about right. Now that the TWI has risen again, the RBNZ may return to its previous rhetoric.

The housing market has a new lease of life. This is crucial – the RBNZ put a lot of stock in the housing market having slowed in the last MPS, and the recent resurgence of house price inflation will reinforce the RBNZ's apprehension about keeping interest rates too low for too long. However, it is early days yet. At this stage, the RBNZ will probably only note the revival and will watch and wait.

Revisions to historical GDP data from Stats NZ have shown that the economy grew more over 2015 and 2016 than previously estimated. For the Reserve Bank, this may imply that the output gap is higher and the economy is closer to experiencing inflation pressure than previously thought. The technical nature of this change doesn't make it any less important for the Reserve Bank – it just makes it difficult to communicate.

Global economic data has been strong and global equity prices have risen rapidly, which may imply a more positive environment for New Zealand exporters. This will rate a mention from the RBNZ, but probably won't affect their overall assessment much.

The RBNZ's inflation forecast will be boosted by the stronger housing market, the higher level of GDP and the stronger global economy, but will be reduced by the higher exchange rate and the fact that actual inflation was lower than expected. Overall, the balance of recent data is roughly neutral from the RBNZ's perspective.

Changes afoot

The second reason to expect a steady-as-she-goes statement from the RBNZ is the transitional nature of the Bank's current leadership and legal framework. Adrian Orr takes the reins as Governor on March 27. He will sign a new Policy Targets Agreement (PTA), which is likely to include some reference to labour market conditions. And later, the law will likely change such that the RBNZ will be required to target labour market conditions alongside inflation. The exact nature of these legal changes is not yet known, creating more uncertainty as to what the OCR will do in the future. Cautious signalling would be a reasonable response to such uncertainty.

Peer review

We have long argued that the RBNZ's GDP growth and house price forecasts for 2018 are too optimistic, and that inflation will be lower than the RBNZ anticipates. The Government may be planning something of a fiscal boost to the economy, but it also plans a range of measures specifically designed to cool the housing market and slow net migration. We think these measures will have a more marked effect on house prices than the RBNZ anticipates, and a slower housing market would in turn impact GDP growth. Moreover, the recent sharp decline in business confidence portends weaker GDP growth in the short run. Hence our GDP forecast is markedly lower than the RBNZ's previously published forecasts. Slower GDP growth naturally leads us to fret less about inflation accelerating. But there is another leg to our lower inflation view. A range of factors including new technology have also been supressing inflation for years, and we expect this trend will continue – we doubt that inflation would accelerate in the fashion the RBNZ expects, even if GDP growth did accelerate.

So on all fronts we see more risk of the OCR rising later than the RBNZ is forecasting, rather than earlier. Our forecasts see the OCR rising only at the end of 2019, and we have even occasionally warned that there is a still a risk of OCR cuts.

In contrast to our views, financial markets are priced as though the RBNZ will raise the OCR in late-2018 or early-2019. Interest rate markets would be unfazed if next week the RBNZ issued a statement along the lines we propose, and would react little. The exchange rate is more likely to react on the day. If, as we expect, the RBNZ expresses its disappointment about the higher exchange rate, the NZD will fall on the day. Conversely, if the RBNZ fails to rail against the rising Kiwi, the NZD will rise in relief. Rare is the *Monetary Policy Statement* that produces no exchange rate reaction in one direction or the other.

Over the course of 2018, we expect interest rate markets will increasingly push its pricing of OCR hikes, anticipating ever-later OCR hikes (similar to 2017). However, next week is not likely to be the start of this process.

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