Clean slate

Preview of RBNZ Monetary Policy Statement, 10 May 2018

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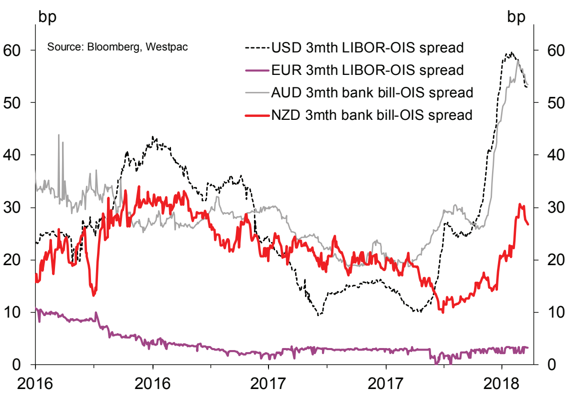
- Next week's MPS will reveal a great deal about Adrian Orr's style and how the OCR will be affected by the new PTA.
- We don't expect a change in the OCR outlook. But if there is a change, it will be in the direction of slightly earlier hikes than previously signalled.
- The wording of the MPS and the press release will be different, but markets shouldn't necessarily take that as a signal – it might just reflect the new Governor's communication style.
- The RBNZ's new labour market directives probably won't cause a change in the OCR outlook this time.
- However, the labour market target might matter at other points in time.

Spread between bank bills and cash rate expectations, selected countries



Next week the Reserve Bank will deliver the first Monetary Policy Statement (MPS) under its new Policy Targets Agreement and under Governor Adrian Orr. We expect that the OCR outlook will be similar to what the RBNZ published in the February MPS, although if there is a change it will be towards slightly earlier OCR hikes. However, the text of the MPS could be quite different to past missives.

For over a year now, the Reserve Bank has consistently delivered the same message. Inflation is too low, and the OCR will remain low until that is rectified. In its last communique the RBNZ expected that would mean keeping the OCR at 1.75% until mid to late 2019, but like all forecasts, that is subject to change.

Recent economic developments have been, on balance, slightly positive for inflation. The exchange rate has dropped sharply below the RBNZ's forecast, the housing market has been stronger than the RBNZ expected, and export commodity prices have risen instead of falling as the RBNZ anticipated. That is more than enough to offset the fact that GDP growth has probably been weaker than the RBNZ expected in the six months to March.

There is, however, a spanner in the works. Bank bills (the interest rates at which banks lend to one another) have risen independent of the OCR over the past month. In Australia and the United States there have been much larger rises in bank bill rates, and the fear is that New Zealand could follow suit. If bank bill rates remain elevated mortgage rates might be pushed up independent of the OCR. And that would reduce even further the RBNZ's desire to lift the OCR. For now we suspect that this is a "watch and wait" issue for the Reserve Bank, but it might make them cautious about changing the OCR outlook.

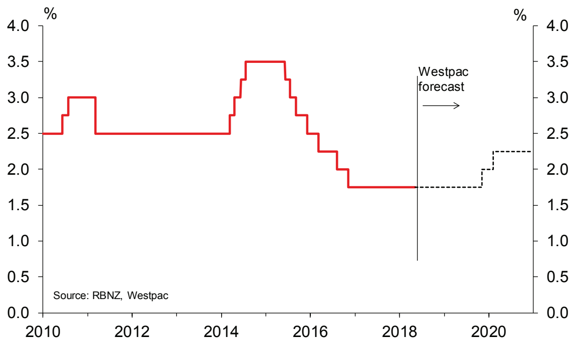
In the scheme of things, recent financial and economic developments are small beer. Collectively, they are not powerful enough to provoke a meaningful change in stance from the Reserve Bank. At best, they warrant a slight upgrade to the OCR forecast, and perhaps some slightly more hawkish details in the text of the MPS and press statement. More likely, the RBNZ will stick to its previous OCR track. If not for the change of Governor, we would absolutely expect a repeat of the same bottom-line phrase that has been used, more or less unchanged, in every MPS and OCR Review since the start of 2017:

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

But we do have a new Governor, a new Policy Targets Agreement, and a plan to change the governance structure of monetary policy. Whether or not the RBNZ sticks with that same bottom-line guidance paragraph, or indeed the other key elements of the press release, is uncertain. The new Governor might want to emphasise continuity by sticking with the old phrase. He may want to re-write the press release just to stamp his own style on the document. Or he might have a genuinely different take on the economy that influences the RBNZ's stance and therefore prompts a change in communication – we have no way of telling which it will be.

What we can say, though, is that if the RBNZ does change its phraseology, that won't *necessarily* be a signal to markets. Normally, traders can quickly parse RBNZ statements for small wording changes, enabling them to quickly decipher any coded message about a change in monetary policy stance. Not so this time. Any wording change might simply reflect how the new Governor's way of expressing things.

Official Cash Rate forecasts



Maximum sustainable employment

We can be certain that the press release and the content of the MPS will have much more to say about the labour market, reflecting the requirements in the new Policy Targets Agreement for the RBNZ to contribute to supporting maximum sustainable employment within the economy, avoid unnecessary volatility in employment, and to explain how it is contributing to maximum sustainable employment.

The more important question is whether the new PTA will cause the RBNZ to alter the stance of monetary policy – and if so, in which direction.

The unemployment rate has dropped to 4.4%. The question is how this compares to "maximum sustainable employment". A "hawkish" interpretation that the labour market is already beyond maximum sustainable employment might emphasise that the employment to GDP ratio is extremely high, and that firms' reported difficulty finding labour is at a cyclical extreme. A "dovish" interpretation that employment has room to grow before reaching its maximum sustainable level would point to wage growth, which has been stubbornly low for years and actually fell at the latest read. The dovish interpretation might also get support from the underutilisation rate, which at 11.9% is further from historical lows than unemployment.

The question of how employment compares to the maximum sustainable level will be hotly debated at the RBNZ. We suspect the RBNZ will conclude that the labour market is currently around neutral or a little tight, based on their assertion that the NAIRU was 4.7% in February. Either way, the RBNZ is forecasting the labour market to tighten from here, meaning it thinks employment will move above the maximum sustainable level in the future. The labour market will not be seen as needing assistance to reach target in the same was as inflation needs a boost – if anything, the RBNZ might worry that keeping the OCR too low for too long risks overheating the labour market and generating unnecessary volatility.

That should make the RBNZ more cautious about keeping the OCR low than if it had a pure inflation target. But the RBNZ did not have a pure inflation target before. The RBNZ has long been required to avoid unnecessary instability in output, interest rates and the exchange rate, and to have regard to the stability of the financial system. These requirements already had the RBNZ saying that it did not want to lower the OCR too far for fear of inflaming the housing market. The RBNZ said it was prepared to wear the consequence that inflation would rise back to target only gradually.

At the current juncture, we suspect that the additional focus on the labour market will neither increase nor decrease the RBNZ's caution about keeping the OCR low. But that's not to say the labour market target could never make a difference – over the past five years or so the RBNZ would have been more prepared to lower the OCR if it had had a labour market target, because back then employment did need assistance to reach the maximum sustainable level.

Market reaction

There is a risk of greater-than-usual market volatility in the first hour or so after this MPS is released. If the form of the MPS does change as we expect, markets will take a while to divine the key messages – particularly because economists no longer get to parse the document under embargo before it is released.

If the RBNZ keeps the OCR outlook broadly unchanged, we suspect there would be no material market reaction once the initial volatility has settled down.

If the OCR outlook is upgraded to slightly earlier hikes, markets would respond by sending swap rates a few basis points higher. The NZD might also rise slightly, particularly if the RBNZ mentions directly the recent fall in the exchange rate. However, the NZD is in such a powerful downdraught at present that any rise in the exchange rate would be short lived.

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