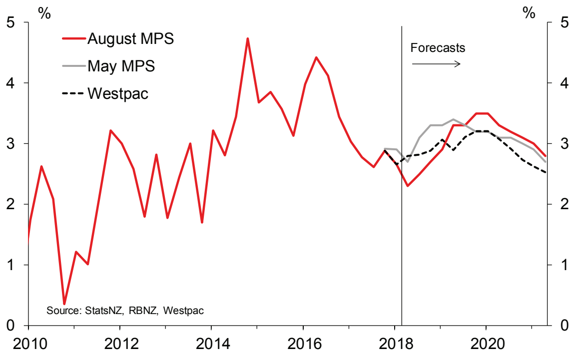
Snap back to reality

Review of the August 2018 Monetary Policy Statement

9 August 2018

- The Reserve Bank repeated its message that the Official Cash Rate (OCR) will remain low for a long period of time, and that the next move could be up or down.
- The RBNZ has now accepted that economic growth is falling short of its bullish forecasts.
- Consequently, they have pushed out the expected date for OCR hikes.
- The intensity of the RBNZ's reaction today to the slowdown in growth surprised us and financial markets.
- We now see a risk that the OCR starts rising even later than our long-held forecast of late 2019.

Figure 1: GDP growth forecasts



As we expected, the Reserve Bank's August *Monetary Policy Statement* repeated the key lines from previous reviews. The next move in the OCR could be either up or down, but more generally interest rates will need to remain at low levels for a considerable period of time – indeed, even longer than the RBNZ previously thought.

We were saying at the start of this year that the RBNZ's growth forecasts were too optimistic, and that as they came to realise this they would shift to a more dovish stance. This has now come to pass. At the time, financial markets and many forecasters were still predicting OCR hikes this year; the centre of gravity has now shifted towards a much later move.

If anything, the RBNZ has shifted its assessment even further in this direction than we expected. The projected OCR track remains flat until September 2020, a year later than in the May *MPS*. From there the next projected move is up, but at a very gradual pace.

The inflation and employment outlooks didn't really play a role in this assessment. Inflation is expected to gradually track towards the 2% midpoint of the target, but with risks either side of this track. The balance of labour market indicators suggest that employment is around its maximum sustainable level, and the central view is for a further gradual fall in unemployment.

What has changed is the RBNZ's outlook for economic growth. GDP growth has slowed in the last few quarters, and the RBNZ has carried this through into its near-term forecasts. In addition, the RBNZ appears to be more wary of the downside risks stemming from global trade tensions, weak business confidence and the slowdown in the housing market.

Notably, the *MPS* included two risk scenarios. The upside scenario, a faster than expected pickup in inflation, would warrant a higher OCR, but with the first move still held off until late next year. Meanwhile, the downside scenario of slower than expected GDP growth – even though accelerating from its current pace – was consistent with OCR cuts from next year.

While we agree that growth has passed its peak, we think that the RBNZ has actually overplayed the near-term softness angle. The RBNZ is expecting a 0.5% rise in June quarter GDP; our indicators put it closer to 1%, though with some likely one-off factors that will overstate the degree of rebound. If we're right, the RBNZ may find that some of the downside risks to growth have dissipated by the time it comes to its next *MPS*.

Nevertheless, the RBNZ's central view now looks similar to our own forecasts, and doesn't suggest a need for action on the OCR for a considerable time. GDP growth is expected to pick up to 3.3% over 2019, supported by low interest rates, increased government spending and a rebound in export volumes. The Kiwibuild programme will help to boost construction activity, although the RBNZ has adopted the Treasury's view that Kiwibuild will ramp up more slowly than previously expected. Above-potential growth would lead to greater capacity pressures and a lift in wage and price inflation.

However, there are some factors moderating the growth outlook. Weak business confidence could weigh on hiring and investment in the near term, and the subdued housing market is likely to suppress household spending growth. Incidentally, RBNZ Governor Orr noted in the press conference that house prices have softened and bank lending practices have moderated, so a review of their loan-to-value ratio restrictions may be in order.

The RBNZ expects inflation to gradually track higher over the coming years. The various measures of underlying inflation have now picked up from their lows, and increasing capacity pressures should support a further lift in domestically-generated inflation. In contrast, tradables inflation is expected to remain below average, reflecting subdued overseas inflation and competitive pressures. Put together, the RBNZ doesn't expect inflation to reach the 2% midpoint of the target until early 2021.

Westpac's OCR forecast

The RBNZ's outlook on the economy has moved broadly into line with our own. However, the remaining points of difference are that we expect lower inflation next year, mainly due to an expected drop in global oil prices, and we expect moderately higher unemployment in the near term.

Our forecast has long been that the OCR will remain on hold until late 2019, and will rise slowly thereafter. For a long while that was the most dovish forecast in the market. But the intensity with which the RBNZ today pushed out its own forecast of OCR hikes does raise the question of whether even our forecast is too hawkish – clearly, the risks now look skewed towards an even later start date for OCR hikes.

Figure 2: Official Cash Rate

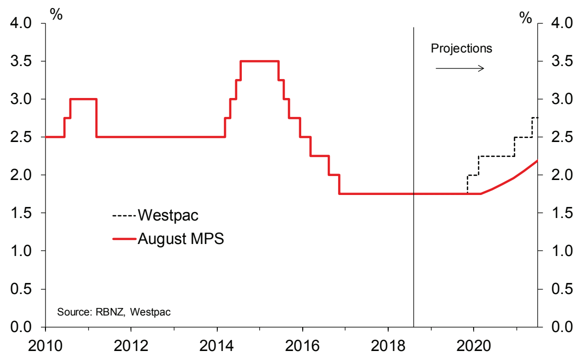
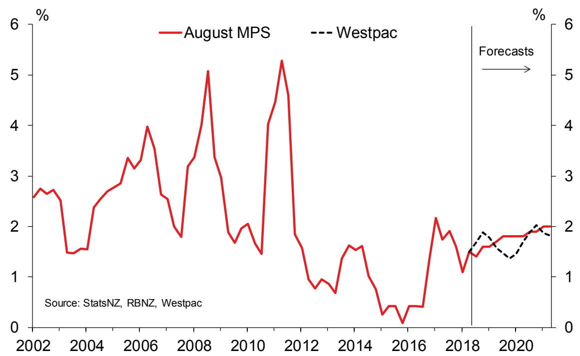


Figure 3: Inflation forecasts



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