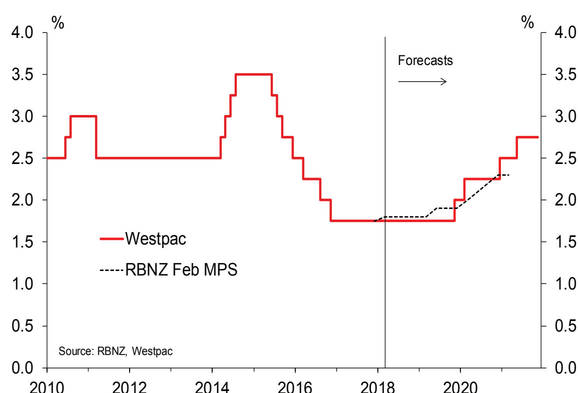
Stay on target

Review of the February 2018 Monetary Policy Statement

8 February 2018

- As expected, the RBNZ left the OCR unchanged and repeated its neutral guidance for the OCR outlook.
- However the RBNZ's thinking has become more dovish, with a downgrade to the inflation outlook.
- The RBNZ still expects to keep the OCR unchanged until around mid-2019, before gradually lifting interest rates.
- The RBNZ's GDP forecasts still look too optimistic to us. We expect the recent plunge in business confidence combined with a housing market slowdown will lead to slower GDP growth in 2018 than the RBNZ expects.
- Consequently, we think the risks are tilted towards later OCR hikes than the RBNZ is currently planning.

Figure 1: Official Cash Rate forecasts



The main features of today's *Monetary Policy Statement* were the same as previous missives from the central bank. The OCR forecast was unchanged from the one published in November, and the RBNZ repeated the policy guidance paragraph that it has been using for a year now:

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

However, beneath the surface we perceived a slightly more dovish tone to the RBNZ's outlook. The overall tenor of the *Monetary Policy Statement* emphasised the recent slowdown in GDP growth and the persistence of low inflation more than the upside surprises such as the stronger housing market. The RBNZ downgraded its assessment of how much the Government's spending plans will stimulate the economy. This, combined with the recent downside surprise on December 2017 CPI, caused the RBNZ to lower its inflation forecasts – it now forecasts that inflation will remain a little below 2% until 2020. The RBNZ has opted to accept lower inflation rather than react by lowering the interest rate outlook, because it fears that excessively low interest rates could unhelpfully overstimulate the housing market.

Markets reacted to this slightly more dovish tone by marking two-year swap rates one basis point lower and the exchange rate down by half a cent.

The best laid plans

Inflation has spent most of the past six years below the mid-point of the RBNZ's target range, and is still too low for comfort. With other countries around the world also experiencing persistently low inflation, there seems little prospect of tradables inflation correcting this. Instead, the RBNZ plans to boost domestically generated inflation (non-tradables inflation) until overall inflation returns to 2%. To achieve this, the RBNZ will have to keep interest rates low and stimulate the economy to perform above its "non-inflationary" speed limit for a sustained period.

The difficulty is that the economy has been slowing recently, due to the cooling housing market, slowing Canterbury rebuild and other factors. The RBNZ now assesses that the economy is roughly operating at around

its non-inflationary speed limit – the output gap has been falling and is now about zero. The RBNZ is not getting the traction that it expected when it dropped the OCR to 1.75%.

We agree with the RBNZ's assessment of the economy's current position. Another way to assess inflationary pressures in the economy is to look at the unemployment rate, which at 4.5% looks to be at around a neutral level in both our assessment and the RBNZ's.

The RBNZ expects that annual GDP growth will accelerate to 3.4% this year, and 3.5% next year. This, the RBNZ expects, will push the output gap into positive territory and the unemployment rate down to 4.2%, which in turn will finally achieve the long-desired acceleration in non-tradables inflation.

The RBNZ is now more moderate about its 2018 GDP growth forecasts than it was in November (see figure 2). However, we still think the RBNZ is expecting too much of the New Zealand economy. In our view, the recent plunge in business confidence portends a slowdown in business investment that the RBNZ has not allowed for. Furthermore, we expect the Government's upcoming changes to the tax treatment of investment housing, the foreign buyer ban, gradually rising fixed mortgage rates and lower net migration will slow the housing market later this year. A slow housing market would, in turn, lead to slower consumer spending than the RBNZ anticipates. Finally, we doubt that construction activity will accelerate in 2019 to the extent that the RBNZ expects, even with the KiwiBuild scheme in operation. Capacity constraints in the construction industry are just too binding.

If we are correct, GDP growth this year and next will fall short of the RBNZ's expectations (figure 2 compares our latest thinking to the RBNZ's published forecasts). Consequently, we doubt that non-tradables inflation will accelerate to the extent that the RBNZ expects (figure 3).

With all of this in mind, we find calls for OCR hikes this year to be well off the mark, and consider market pricing for a hike around the turn of the year to be too eager. We expect that the RBNZ will have to leave the OCR at its current low level for longer than it currently anticipates – we don't foresee an OCR hike until late-2019. If anything, we would put the odds of an OCR reduction this year as slightly higher than the odds of a hike, although a large shock would be required to generate either.

Dominick Stephens
Chief Economist

Figure 2: GDP growth forecasts

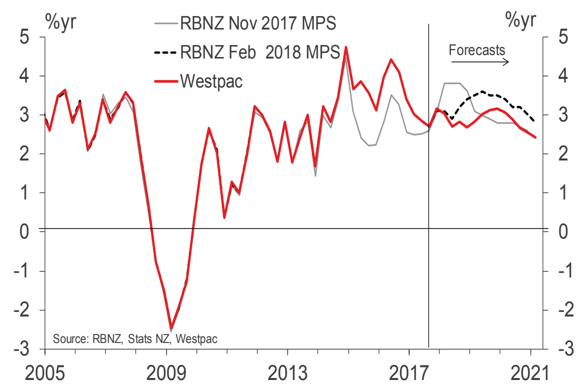
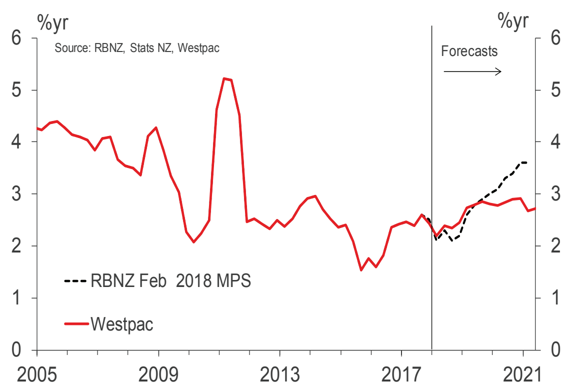


Figure 3: Non-tradables inflation



Side by side of the November Monetary Policy Statement and February Monetary Policy Statement

- key changes highlighted

Official Cash Rate unchanged at 1.75 percent 9 November 2017	Official Cash Rate unchanged at 1.75 percent 8 February 2018
Reserve Bank today left the Official Cash Rate (OCR) unchanged at 1.75 percent.	The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 1.75 percent.
Global economic growth continues to improve, although inflation and wage outcomes remain subdued. Commodity prices are relatively stable. Bond yields and credit spreads remain low and equity prices are near record levels. Monetary policy remains easy in the advanced economies but is gradually becoming less stimulatory.	Global economic growth continues to improve. While global inflation remains subdued, there are some signs of emerging pressures. Commodity prices have increased, although agricultural prices are relatively soft. International bond yields have increased since November but remain relatively low. Equity markets have been strong, although volatility has increased recently. Monetary policy remains easy in the advanced economies but is gradually becoming less stimulatory.
The exchange rate has eased since the August Statement and, if sustained, will increase tradables inflation and promote more balanced growth.	The exchange rate has firmed since the November Statement, due in large part to a weak US dollar. We assume the trade weighted exchange rate will ease over the projection period.
GDP in the June quarter grew broadly in line with expectations, following relative weakness in the previous two quarters. Employment growth has been strong and GDP growth is projected to strengthen, with a weaker outlook for housing and construction offset by accommodative monetary policy, the continued high terms of trade, and increased fiscal stimulus.	GDP growth eased over the second half of 2017 but is expected to strengthen, driven by accommodative monetary policy, a high terms of trade, government spending and population growth. Labour market conditions continue to tighten. Compared to the November Statement, the growth profile is weaker in the near term but stronger in the medium term.
The Bank has incorporated preliminary estimates of the impact of new government policies in four areas: new government spending; the KiwiBuild programme; tighter visa requirements; and increases in the minimum wage. The impact of these policies remains very uncertain.	The Bank has revised its November estimates of the impact of government policies on economic activity based on Treasury's HYEFU. The net impact of these policies has been revised down in the near term. The Kiwibuild programme contributes to residential investment growth from 2019.
House price inflation has moderated due to loan-to-value ratio restrictions, affordability constraints, reduced foreign demand, and a tightening in credit conditions. Low house price inflation is expected to continue, reinforced by new government policies on housing.	House price inflation has increased somewhat over the past few months but housing credit growth continues to moderate.
Annual CPI inflation was 1.9 percent in September although underlying inflation remains subdued. Non-tradables inflation is moderate but expected to increase gradually as capacity pressures increase. Tradables inflation has increased due to the lower New Zealand dollar and higher oil prices, but is expected to soften in line with projected low global inflation. Overall, CPI inflation is projected to remain near the midpoint of the target range and longer-term inflation expectations are well anchored at 2 percent.	Annual CPI inflation in December was lower than expected at 1.6 percent, due to weakness in manufactured goods prices. While oil and food prices have recently increased, traded goods inflation is projected to remain subdued through the forecast period. Non-tradable inflation is moderate but expected to increase in line with increasing capacity pressures. Overall, CPI inflation is forecast to trend upwards towards the midpoint of the target range. Longer-term inflation expectations are well anchored at 2 percent.
Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly.	Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly.

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