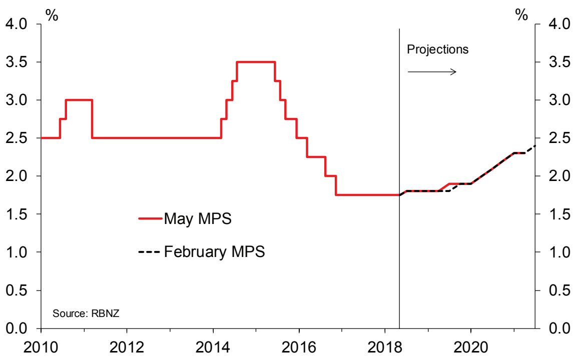
In with the new

Review of the May 2018 Monetary Policy Statement

10 May 2018

- The RBNZ has shaken up the form of its *Monetary Policy Statement* with an improvement in clarity.
- But the actual OCR outlook is much the same – the OCR is firmly on hold.
- The RBNZ came right out and stated that employment is currently close to the maximum sustainable level. That took guts, and is tantamount to telling the Government that its target of 4% unemployment is not currently achievable on a sustained basis.
- There was much discussion of how the labour market will influence the OCR in future.
- The RBNZ cited the risk of overheating the labour market as a reason to eschew OCR cuts.
- The RBNZ all but ignored the housing market and exchange rate in the MPS.
- We continue to expect no change in the OCR until November 2019.

Figure 1: Official Cash Rate forecasts



As expected, the Reserve Bank served up a refreshing *Monetary Policy Statement (MPS)* under new Governor Adrian Orr, with straightforward language and an infographic. It seems the much hoped-for improvement in RBNZ communication is coming to pass.

Beneath those cosmetic changes there were also a few substantive issues that stuck out for us, which we will discuss one by one:

- The actual outlook for the OCR is much the same as it was before. The RBNZ intends to keep the OCR on hold for a considerable period.
- This is despite the fact that the GDP and inflation outlooks have been downgraded slightly.
- The RBNZ believes that employment is currently close to its maximum sustainable level, and discussed at length how it will measure this concept going forward.
- Discussion on the exchange rate and the housing market were notably absent from the *MPS*.

The outlook for the OCR, GDP and inflation

The outlook for the OCR was very similar to the outlook given in February. The words used to describe the on-hold stance were blunter than in previous communications, and gave even less encouragement to those who are looking for OCR hikes:

"The Official Cash Rate (OCR) will remain at 1.75 percent for some time to come. The direction of our next move is equally balanced, up or down. Only time and events will tell."

The actual OCR forecast was the barest shade lower (a tenth of a percent lower in a single quarter). In one sense, we were surprised about the direction of that change, given that the exchange rate has fallen and the housing market has proved stronger than expected. But in another sense we agree with the shift in view, tiny as it is. The RBNZ was more influenced by the fact that construction activity is stalling and GDP growth is falling short of forecasts. We think that is appropriate. The RBNZ has come incrementally closer to our view that a slowing economy might make it very difficult to boost inflation, and consequently the OCR will not need to rise until the end of 2019.

The very slight dovish shift from the RBNZ caused the New Zealand dollar and interest rates to fall, but only slightly.

The RBNZ's reasoning was similar to previous *MPSs,* although there is now an employment element to the story. Inflation is currently too low, with core inflation running around 1.5%. This has mainly been due to very low tradables inflation. In order to rectify low inflation, the RBNZ plans to keep the OCR low for a long period, which will generate stronger GDP growth and rising non-tradables inflation.

The RBNZ has long been loath to reduce the OCR further and push inflation up to target faster. But the reasoning for this now cites employment rather than the housing market. The RBNZ judges that employment is currently close to the maximum sustainable level. Reducing the OCR below 1.75% "risks creating unnecessary volatility in output, employment and interest rates", and any resulting increase in employment "might not be sustainable." In other words, the RBNZ wants to avoid overheating the labour market more than is necessary to achieve the inflation target.

Maximum sustainable employment

The RBNZ's discussion of how it interprets the new Policy Targets Agreement was very much in line with our understanding. The RBNZ made it clear that inflation takes precedence as a long-run goal with the comment that *"monetary policy's best contribution to long-run economic growth and employment comes through ensuring low and stable inflation,"* and comments that monetary policy cannot influence the level of employment over the long run.

The employment part of the mandate appears to have a shorter-run interpretation. We take this to mean that the state of the labour market might influence how rapidly the RBNZ chooses to return inflation to target – for example, the RBNZ is currently citing the risk of overheating the labour market as a reason not to lower the OCR further.

We were pleased to see the RBNZ emphasise the symmetry of the labour market target with "The bank should not seek to boost employment in the short term at the expense of long-term employment, welfare, or well-anchored inflation expectations." This implies that the RBNZ will seek to avoid overshooting and undershooting maximum sustainable employment with equal vigour. That will please markets and economists, but will displease those who were hoping that the labour market mandate would lead to lower interest rates on average.

The RBNZ came right out and said that employment was currently close to the maximum sustainable level. That took guts – the RBNZ is effectively saying that the Government's target of 4% unemployment is not currently achievable on a sustained basis.

The RBNZ discussed a range of metrics that could be used to ascertain where employment is relative to the maximum sustainable level – known as the employment gap. Being early days, the analysis was light. The RBNZ was most

Figure 2: GDP growth forecasts

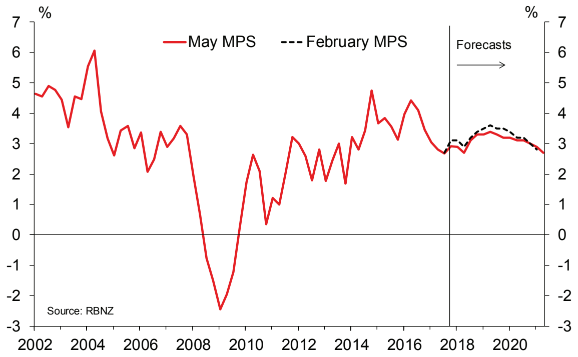
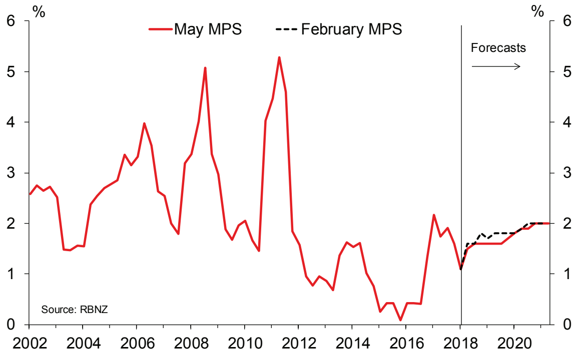


Figure 3: Non-tradables inflation



enthusiastic about the most obvious measure – the unemployment rate. However, there was a hint that the RBNZ would focus on unemployment duration of between one and twelve months, as this is more cyclical than short-term frictional unemployment or long-term structural unemployment. Model-based measures such as the NAIRU were seen as having wide uncertainty bands, while alternative statistics such as the underemployment rate were seen as less indicative of labour market pressure. We were surprised that the RBNZ did not consider survey evidence, such as firms' reported difficulty finding labour or households' confidence about their job prospects, in the mix. We certainly consider that type of evidence when assessing the employment gap.

The RBNZ based its assessment of various measures of the employment gap on how correlated they were with wage growth. The idea is that if employment really is below (above) the maximum sustainable level, wage growth soon afterwards should be below (above) normal. Wage growth therefore constitutes evidence as to the employment gap.

Right now, wage growth is lower than would normally be expected for this stage of the economic cycle, and has undershot the RBNZ's forecasts. This may imply that employment is below the maximum sustainable level, that unemployment can safely be pushed down further, and that the OCR can be kept lower for longer. This is an issue we will be looking into in more detail, and presumably one that the RBNZ will address at the next *MPS*.

The mysterious disappearing exchange rate and housing market

We were very surprised that the RBNZ all but ignored the housing market and the exchange rate in the *MPS*. In the press conference, the Governor brushed aside questions on the exchange rate, and the housing market was not a big focus for questions.

It was disappointing that the RBNZ did not publish a house price forecast, because that will make it harder to assess how emerging housing market data might influence the RBNZ. This was a reduction in transparency from an RBNZ which has been very transparent in other ways.

But overall, removing the housing market and exchange rate from the monetary policy headlines has got to be positive. The RBNZ has a long history of obsessing over the exchange rate and engaging in fruitless attempts to lower it. At best this has diverted attention from issues monetary policy can actually influence, and at worst it has led to serious monetary policy errors (namely the failure to lift interest rates rapidly enough in the mid-2000s).

We will be pleased if the RBNZ under Adrian Orr continues as it has started, accepts the exchange rate for what it is, and gets on with the job. However, we do note that in his first speech Graeme Wheeler made the orthodox point that monetary policy cannot affect the exchange rate on a sustained basis, but by the end of his of his tenure the RBNZ appeared to be consistently shaping monetary policy communications with the aim of lowering the exchange rate.

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