She'll be right

Review of the November 2018 Monetary Policy Statement

8 November 2018

- The Reserve Bank has moved away from the idea of cutting the OCR by removing the phrase that the next move in the OCR could be "up or down."
- But the RBNZ also made it clear that hikes are not expected until mid-2020.
- The *Monetary Policy Statement* acknowledged stronger signs of inflation pressure, but kept the OCR forecast unchanged.
- Extraordinarily, the RBNZ is forecasting that inflation and employment will overshoot the targets in the medium term, yet it is not planning to remedy that by raising the OCR.
- This could become a theme – strong data but a Reserve Bank that declines to forecast a rising OCR.
- The "new" Reserve Bank is more dovish than the old.

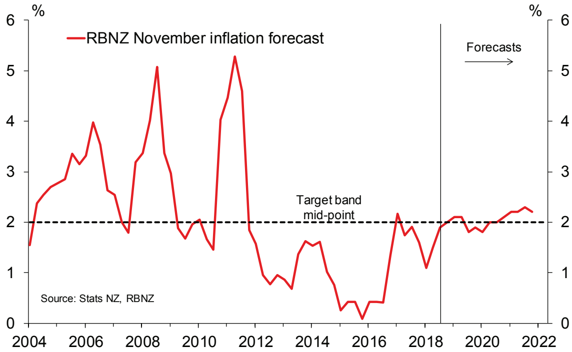
We went into today's *Monetary Policy Statement* expecting a slightly less dovish tone from the Reserve Bank, following a run of very strong data. That's exactly what we got. The Reserve Bank moved away from the possibility that it might reduce the OCR by removing the phrase that the next move in the OCR could be "up or down." Its alternative scenarios were balanced, rather than being skewed to the downside as previously. And the inflation forecast was higher than in previous documents.

At the same time, however, the RBNZ remained adamant that the OCR is not going to rise any time soon. They retained the phrase that the OCR is expected to remain "at this level through 2019 and into 2020." The OCR forecast was a carbon copy of the August forecast, and implied the same – no hike until mid-2020. Much of the rhetoric around growth and employment remained unchanged.

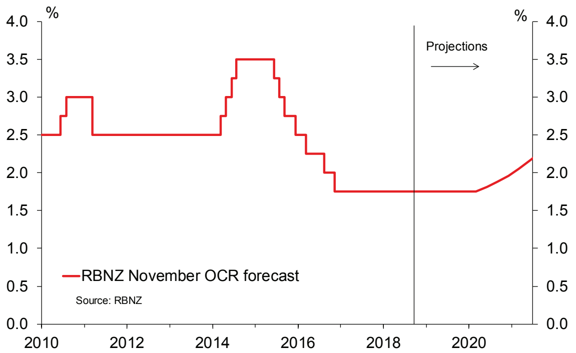
This left a little something for everybody. The overall tone was a slight hawkish shift, not a dramatic change of stance. Markets were prepared for roughly that, particularly since interest rates and the exchange rate rose following yesterday's strong unemployment numbers. So there was very little market reaction today.

Our overall impression is that the Reserve Bank is relaxed and does not want to rock the boat. Things are going the right way for the central bank. Inflation has been too low for years, so signs that it is now rising are welcome. The RBNZ needs the economy to strengthen in order to keep inflation moving the right direction, and recent data confirms that is

The RBNZ now expects longer term inflation to be above 2%...



...but hasn't changed its OCR forecast



on track. The exchange rate, seen as too high for years, has come down. And unemployment is falling without evidence of untoward wage increases.

The Reserve Bank believes that the best thing to do in these circumstances is to leave the OCR low. For now, we tend to agree with that. True, inflation has risen sharply recently, but that is mostly due to rising petrol prices. Scratch beneath the surface and core inflation is only slowly creeping higher after being too low for a long while. We expect economic growth to pick up over the coming year due to the Government's spending binge. But that will apply only gradual further upward pressure to inflation.

The extraordinary aspect of today's *Monetary Policy Statement* was more to do with the Reserve Bank's medium term forecasts. The Reserve Bank is actually forecasting that inflation will rise above the 2% mid-point of their inflation target bank, on a sustained basis over the medium-term. At the same time, they predicted that employment would rise above its maximum sustainable level. In other words, the Reserve Bank is saying that it is going to overshoot its targets. Yet it is not planning to adjust the OCR to avert that miss.

The Reserve Bank is not expected to hit its targets precisely at all times. For example, inflation is forecast to rise above 2% next year (the RBNZ says 2.1%, we say 2.3%). But that's just due to rising petrol prices, so it is no big deal – petrol prices are likely to come down again, and it would be counterproductive for the Reserve Bank to jump at that type of volatility.

But this is not about short term volatility, it is about the medium term. In the past, if the RBNZ had thought inflation was going to rise above target on a sustained basis, it would forecast a rising OCR. The rising OCR would then bring the inflation forecast back down to target.

The situation is more complex now that the RBNZ has both an employment and an inflation target. The RBNZ could understandably forecast above-target inflation if it thought that employment was going to be below target, on the basis of balancing the two targets. But that is not the case here. The RBNZ repeatedly said that it expects employment to rise above its maximum sustainable level for a period. The RBNZ is saying that both employment and inflation are going to be above target, and even though it could remedy that by forecasting a higher OCR, it has chosen not to.

Admittedly, the quanta are small – the forecasts are for inflation and employment to rise only "slightly" above their respective targets. Perhaps the RBNZ has been burned by many years of below-target inflation, and is prepared to take a small risk on the other side for once. Or perhaps it is interpreting differently the requirement to keep inflation "between 1% and 3% over the medium-term, with a focus on keeping future inflation near the 2% mid-point", and is currently aiming for slightly above 2% inflation. Whatever the explanation, this is a small but significant departure from the approach that the previous Governor would have taken.

At every utterance from the Reserve Bank, we learn more about how the new dual mandate and Governor are going to impact interest rates and the economy. Today's MPS reinforces our impression that the "new" Reserve Bank is more dovish than the old. We suspect that the tone of today's MPS is going to become a theme. Over the coming year, we expect the general tone of economic data to improve due to the Government's spending binge and the recent RBNZ-induced drop in mortgage rates that will stimulate housing market. Consequently, we expect core inflation to gradually trend higher. Yet we remain very comfortable forecasting no OCR hike until mid-2020. At each *Monetary Policy Statement* and OCR Review, we expect that the RBNZ will remain sanguine in spite of strengthening data. That could surprise financial markets.

We expect the shift to a committee structure for OCR decisions will reinforce this behavioural change from the Reserve Bank.

Dominick Stephens
Chief Economist

Full text of the RBNZ press release

8 November 2018

Official Cash Rate unchanged at 1.75 percent

The Official Cash Rate (OCR) remains at 1.75 percent. We expect to keep the OCR at this level through 2019 and into 2020.

There are both upside and downside risks to our growth and inflation projections. As always, the timing and direction of any future OCR move remains data dependent.

The pick-up in GDP growth in the June quarter was partly due to temporary factors, and business surveys continue to suggest growth will be soft in the near term. Employment is around its maximum sustainable level. However, core consumer price inflation remains below our 2 percent target mid-point, necessitating continued supportive monetary policy.

GDP growth is expected to pick up over 2019. Monetary stimulus and population growth underpin household spending and business investment. Government spending on infrastructure and housing also supports domestic demand. The level of the New Zealand dollar exchange rate will support export earnings.

As capacity pressures build, core consumer price inflation is expected to rise to around the mid-point of our target range at 2 percent.

Downside risks to the growth outlook remain. Weak business sentiment could weigh on growth for longer. Trade tensions remain in some major economies, raising the risk that trade barriers increase and undermine global growth.

Upside risks to the inflation outlook also exist. Higher fuel prices are boosting near-term headline inflation. We will look through this volatility as appropriate. Our projection assumes firms have limited pass through of higher costs into generalised consumer prices, and that longer-term inflation expectations remain anchored at our target.

We will keep the OCR at an expansionary level for a considerable period to contribute to maximising sustainable employment, and maintaining low and stable inflation.

Meitaki, thanks.

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