Uncertainty reigns

RBNZ OCR Review, June 2018

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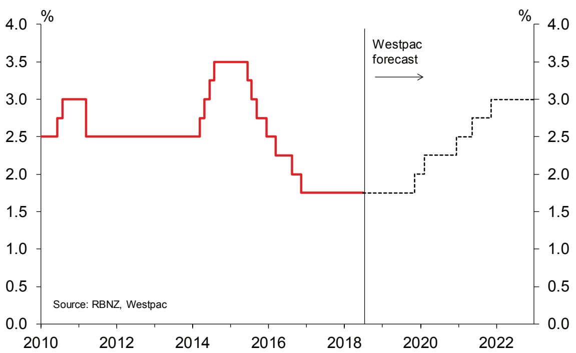
- The Reserve Bank reiterated that the OCR is expected to remain low, but gave no guidance about the timing or direction of the next move.
- Overall, this Review sounded slightly more dovish than previous RBNZ communications.
- The RBNZ's communication style is shifting towards emphasising uncertainty.
- The RBNZ is becoming less bullish about economic growth. We were surprised that the RBNZ shifted its view on that today.
- In the bigger picture, the RBNZ's forecasts and financial market pricing are converging on our long-held views. The economy will be mixed in 2018, and the OCR will not need to rise until November 2019.
- The RBNZ assessed the Government's May Budget as less stimulatory for the economy than previous forecasts. We disagree with that.

Official Cash Rate



The only thing about the future that economists can really be sure of is that their forecasts will be wrong – some unexpected event or "flapping of a butterfly's wings" will inevitably have unanticipatable consequences. The Reserve Bank really ran with that in today's OCR Review, strongly emphasising the uncertainty about the OCR outlook and offering nothing in the way of guidance about the timing or direction of the next move. The RBNZ simply stated that the OCR would remain at 1.75% for now, and could move either direction, at any time, as necessary. However, it did later say that the OCR would remain at an expansionary level for a considerable period.

We regard this shift to agnosticism mainly as a reflection of the new Governor's communication style. It is not, in and of itself, a sign that the RBNZ thinks the inflation outlook has changed.

That said, the details beneath the headline of today's OCR Review were slightly more dovish than we anticipated. The RBNZ pointed to weaker domestic economic data and global trade tensions, and, surprisingly, said that they regarded the outlook for fiscal policy as less stimulatory than before. Together, this implies that the RBNZ has lowered its assessment of medium-term inflationary pressures. Markets, however, did not react to the Review, perhaps because interest rates had already fallen on yesterday's weak business confidence numbers.

Both the Reserve Bank and financial markets are slowly coming around to our long-held view that 2018 will be a slow year for the New Zealand economy, not one of accelerating growth. Consequently, there has been a convergence of opinion about the OCR outlook – neither financial market pricing nor the RBNZ's forecasts are significantly different to our long-held forecast that the next move in the OCR will be a hike in November 2019.

The RBNZ's guidance paragraph was:

"The Official Cash Rate (OCR) will remain at 1.75 percent for now. However, we are well positioned to manage change in either direction – up or down – as necessary."

Three features of that paragraph stood out:

(1) The RBNZ said the OCR would remain at 1.75 percent "for now", whereas previously it had said "for some time to come" or "for a considerable period." This emphasises that the RBNZ is uncertain about when the OCR might move, rather than signalling an imminent move.

(2) The RBNZ retained the phrase "up or down." Financial markets had latched onto those three words and removing them would have been interpreted as a sign that the RBNZ is readying to increase the OCR. The RBNZ wisely avoided sending such a signal.

(3) Other than "up or down", the phraseology of the guidance paragraph was different to the May MPS paragraph. This was expected. The RBNZ is trying to avoid the formulaic communications. It wants markets to read each statement individually, rather than making side-by-side comparisons between the exact wording of two statements.

The RBNZ finished with *"The best contribution we can make to maximising sustainable employment, and maintaining low and stable inflation, is to ensure the OCR is at an expansionary level for a considerable period."* Again, the words were different to the corresponding paragraph from May, but the meaning was the same.

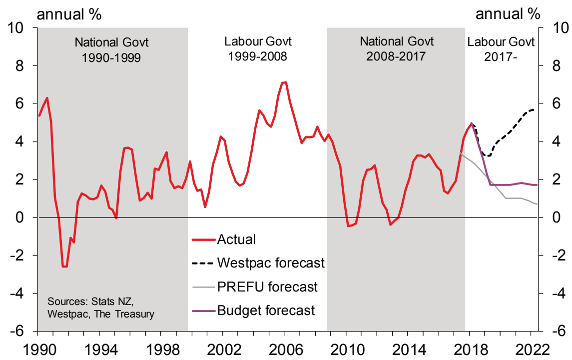
Between these two summary paragraphs, the RBNZ detailed how the economic and inflation outlook had changed since May. The headline was that the outlook described in May "remains intact." However, the balance of subsidiary details was to the downside. The RBNZ cited trade tensions and volatility in emerging markets as tempering the global economic outlook. They did mention that inflation would push higher in the near term due to rising petrol prices, but chose not to make a big deal of that. Meanwhile, on the domestic economy the RBNZ noted the recent weak GDP outturn and said that "the Government's projected spending impulse is slightly lower and later than anticipated." This last part really surprised us, and is discussed in more detail below.

It appears that the RBNZ is becoming less bullish about the economic outlook. The August *Monetary Policy Statement* may feature lower GDP growth forecasts than the May *MPS*. The housing market did not rate a mention from the RBNZ today, but we suspect it is losing altitude more rapidly than the RBNZ anticipated, potentially reinforcing the RBNZ's thoughts of a slower economy. In turn, this could lead the RBNZ to publish a lower OCR forecast in the August *MPS*, although that will depend critically on the exchange rate. If the exchange rate continues to fall, the inflationary consequences might be enough to balance the slowing economy and housing market.

Not stimulating enough?

In May, the Government delivered a Budget featuring $2.4bn of extra spending allowances. At the time we said "The ramp up in spending in this Budget will have inflationary consequences for the economy. Treasury thought these would be significant, and forecast OCR hikes early next year. We view any inflationary consequence as more minor." In other words, both Westpac and Treasury thought that the Government had delivered a stimulatory Budget that would boost the economy and create inflationary pressures. Treasury publishes a summary measure of "fiscal stimulus" each Budget, which is an assessment of how the Government's policy changes will impact GDP. This suggested that the Budget spending plans would boost the economy by about one percent of GDP extra in 2020/21, compared to the previous Government spending plan.

Real government consumption growth



We were very surprised to learn that the RBNZ views the Government's projected spending as less stimulatory than before. Part of the difference of opinion may relate to KiwiBuild. While the Budget announced a lift in Government spending, the Treasury's forecasts also featured a delayed profile for KiwiBuild construction activity. We know that the RBNZ has been putting a lot of weight on the impact that KiwiBuild will have on the economy. Presumably, the RBNZ views the KiwiBuild delay as more important than the ramp up in Government spending. By contrast, we don't view KiwiBuild as particularly important for the economic outlook, because it will mostly displace private sector building that would have occurred anyway.

A second point of difference may be that, compared to us, the RBNZ has a much lower forecast of real Government consumption spending (Government spending on things like education and health, adjusted for inflation). The RBNZ uses the Treasury's Government consumption forecast as a baseline, and that baseline is far too low in our view. Our own forecasts for Government consumption look much more typical for a Labour-led Government.

Overall, we are content to disagree with the RBNZ's assessment that Government spending is becoming less stimulatory.

Dominick Stephens
Chief Economist

Full RBNZ statement

Tena koutou katoa, welcome all.

The Official Cash Rate (OCR) will remain at 1.75 percent for now. However, we are well positioned to manage change in either direction – up or down – as necessary.

Our outlook for the New Zealand economy, as detailed in the May Monetary Policy Statement, remains intact. Employment is around its sustainable level and consumer price inflation remains below the 2 percent mid-point of our target, necessitating continued supportive monetary policy for some time to come.

Global economic growth is expected to support demand for our products and services. Global inflationary pressure is also expected to be higher but remain modest. This outlook has been tempered slightly by trade tensions in some major economies. Ongoing volatility in some emerging market economies continues.

Domestically, ongoing spending and investment, by both households and government, is expected to support growth. However, the recent weaker GDP outturn implies marginally more spare capacity in the economy than we anticipated. The Government's projected spending impulse is also slightly lower and later than anticipated.

CPI inflation is likely to increase in the near term due to higher fuel prices. Beyond that, inflation is expected to gradually rise to our 2 percent annual target, resulting from capacity pressures.

The best contribution we can make to maximising sustainable employment, and maintaining low and stable inflation, is to ensure the OCR is at an expansionary level for a considerable period.

Meitaki, thanks.

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