Curtain raiser

RBNZ OCR Review, March 2018

22 March 2018

- As expected, the Reserve Bank left the OCR unchanged at 1.75%, and continued to signal that it expects the OCR to remain on hold for an extended period.
- The RBNZ still expects that the economy will accelerate this year, eventually pulling inflation slowly up towards two percent.
- We doubt very much that the economy will accelerate as the RBNZ expects, but our expectation of exchange rate depreciation leaves us with an inflation outlook that is similar to the RBNZ's.
- The main point is that both we and the RBNZ are much more dovish than financial market pricing, and comfortably so.
- The most interesting aspect of today's RBNZ statement was that it contained no reference at all to the exchange rate, for the first time since 2012.
- From here, attention will turn to the new Policy Targets Agreement between the Minister of Finance and the incoming Governor, to be signed within a day or two.
- One possibility is that the new PTA will revert to a 1 – 3 percent target band for inflation, removing reference to the two percent midpoint. Historical experience suggests that this would become a de facto target of three percent.
- We will be very interested in the exact wording of any reference to the labour market within the new PTA.

Today's OCR Review was never going to be more than a curtain raiser for the main monetary policy event of the month, the signing of a new Policy Targets Agreement between the incoming Governor and the Minister of Finance. First of all, the balance of recent data has been broadly in line with the RBNZ's previous expectations. And in any case, any surprising position taken by the current Governor could easily be superseded when the new Governor takes over in a few days' time.

The press release lived up to those modest expectations, and there was no market reaction to today's OCR Review. The OCR guidance paragraph was the same as has been used, more or less unchanged, since February last year: *"Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly."* The preceding details were mostly descriptive in nature, with nothing to indicate that the RBNZ had materially shifted its views.

Accordingly, we conclude that the RBNZ remains very much in "on hold" mode. Inflation is below target, and in order to rectify this the RBNZ expects that it will have to keep the OCR at its current low level until mid- to late-2019. This low OCR, combined with expansionary fiscal policy, is expected to produce accelerating economic growth and, in time, higher inflation. However, should circumstances evolve differently, the RBNZ is prepared to either cut or hike the OCR as necessary.

Our own position is also unchanged. We doubt very much that the economy will accelerate in the way that the RBNZ expects, mainly because we expect that house prices will be weaker than the RBNZ is forecasting. However, our exchange rate forecast is lower than the RBNZ's, leaving us with a forecast for inflation that is only slightly weaker than the RBNZ's. On balance, we think there is slightly less need to hike the OCR than the RBNZ is projecting, but the difference is minor. The main point is that both we and the RBNZ are much more dovish than current financial market pricing – comfortably so, in both cases.

In the details of the press release, the RBNZ did acknowledge that GDP was weaker than expected in the fourth quarter of 2017, but said it expects growth to strengthen from here. Similarly, the RBNZ largely dismissed recent stronger housing market data, describing housing price inflation as still moderate.

Perhaps the most interesting aspect of today's press release was that it contained no mention of the exchange rate at all. This is the first monetary policy press release since June 2012 that did not pass comment on the value of the New Zealand dollar. The RBNZ had been expressing discomfort with the degree of market attention paid to its exchange rate commentary in recent times, with minor wording differences causing the New Zealand dollar to jump up or down unnecessarily in the immediate aftermath of every monetary policy missive. The exchange rate has recently traded very much in line with the RBNZ's previous forecast, and is at a level that the RBNZ is comfortable with. So the RBNZ was probably pleased to have an opportunity to further reduce the focus on the exchange rate.

Meanwhile, the labour market did rate a mention. *Although it was only a cursory "Labour market conditions are projected to tighten further,"* it was still a telling sign of the how the RBNZ's focus of attention is shifting in anticipation of changes to the RBNZ law.

We are now turning our attention to the change of Governor at the RBNZ. Within the next few days a new Policy Targets Agreement (PTA) between the Minister of Finance and the incoming Governor will be announced. This PTA will be a precursor to changes to the Reserve Bank Act, which will require the RBNZ to target employment as well as inflation. The Minister of Finance is expecting the new Governor to act from the beginning in the spirit of this law change, so the new PTA will probably contain some reference to the labour market.

The exact wording of this reference to the labour market will be interesting. We would have concerns about a target worded along the lines of "maximum employment", since that is asymmetric and would make it harder to increase interest rates than reduce them. We would prefer symmetrical wording such as targeting "maximum sustainable employment".

The second area of interest is whether there are any changes to how the inflation target within the PTA is worded. At present, the RBNZ is required to target 1 – 3 percent inflation, but there is a specific focus on the two percent midpoint. Recent comments from the Minister of Finance hint at the 1 – 3 percent band being maintained, but made no reference to the two percent midpoint. If the two percent midpoint is removed, our concern is that the defacto target would become three percent, as it was from 2002 until 2012. This might lead to a brief period during which the OCR is lower than otherwise, but in the long run would simply result in higher average inflation and higher average interest rates. Markets would react to such a change in the inflation target by reducing near-term interest rate expectations and simultaneously increasing long-term interest rate expectations, meaning a steeper yield curve. The exchange rate reaction on the day would probably be in the direction of a lower New Zealand dollar.

See overleaf for a line by line comparison between today's press release and the RBNZ's February press release.

Dominick Stephens
Chief Economist

Side by side of the February OCR review and the March *Monetary Policy Statement* - key changes highlighted

Official Cash Rate unchanged at 1.75 percent **8 February 2018**	**Official Cash Rate unchanged at 1.75 percent** **22 March 2018**
The 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. 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 outlook for global growth continues to gradually improve. While global inflation remains subdued, there are some signs of emerging pressures. Commodity prices have continued to increase and agricultural prices are picking up. Equity markets have been strong, although volatility has increased. Monetary policy remains easy in the advanced economies but is gradually becoming less stimulatory.
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 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.	GDP was weaker than expected in the fourth quarter, mainly due to weather effects on agricultural production. Growth is expected to strengthen, supported by accommodative monetary policy, a high terms of trade, government spending and population growth. Labour market conditions are projected to tighten further.
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 increased somewhat over the past few months but housing credit growth continues to moderate.	Residential construction continues to be hindered by capacity constraints. The Kiwibuild programme is expected to contribute to residential investment growth from 2019. House price inflation remains moderate with restrained credit growth and weak house sales.
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.	CPI inflation is expected to weaken further in the near term due to softness in food and energy prices and adjustments to government charges. Tradables inflation is projected to remain subdued through the forecast period. Non-tradables inflation is moderate but is expected to increase in line with a rise in capacity pressure. Over the medium term, 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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