RESEARCH
ECONOMY WATCH

9 November 2017

Tiptoeing Through the Minefield

- **Cash rate unchanged at 1.75%**
- **But RBNZ becomes a trifle hawkish**
- **As inflation forecast raised**
- **And new government policies are embedded into forecasts**
- **We stick with our view that the cash rate will rise in 2018**

Writing today's Monetary Policy Statement must have been a nightmare for RBNZ officials as they, like everyone else, pondered life under a very different parliamentary regime. And it's made all the more difficult by the fact that while the general thrust of new policy is understood, the detail is far from clear – yet.

Additionally, outside of government policy changes, which are, on balance, clearly inflationary, there were increased signs that an inflationary pulse was already developing elsewhere via the lower New Zealand dollar, tightening labour market and strengthening global activity.

How then to acknowledge the rising inflationary pressures that are in evidence while highlighting the uncertainty that prevails and not scaring the horses. Mission impossible?! Not so, it would seem. In a finely crafted statement, the RBNZ has effectively moved to a tightening bias, without saying so, but, in doing so, has seen the NZD TWI rise just 40 basis points even though the majority of commentators took the view that the bank would show no sign of a hawkish shift.

First and foremost, the RBNZ is focused on inflation. And it will remain so even when the Reserve Bank Act is changed. Thus, the most important aspect of the Bank's forecasts is that its short term inflation views have been revised significantly higher, and the annual headline inflation rate gets to 2.0% earlier than previously.

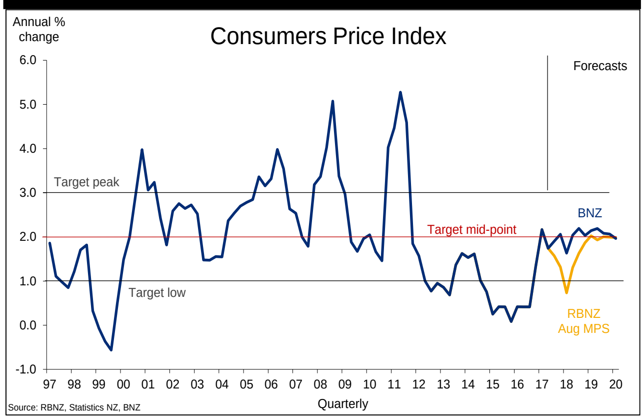
Back in the August MPS, the RBNZ forecast annual CPI inflation would drop to just 0.7% for the year ended March 2018. But this has been thwarted by a combination of a higher than expected September quarter outcome and increasing petrol prices. As a consequence, the low in the RBNZ's inflation cycle is now 1.5%, just a tad lower than our 1.6% pick. This is important as had headline inflation dropped sub 1.0% it would likely have driven inflation expectations lower leading to reduced future inflation and less pressure on wages. Now this is no longer the case.

With short term inflation now more elevated, forecast annual CPI inflation climbs to 2.1% in June 2018 whereas it previously hit 2.0% in March 2019.

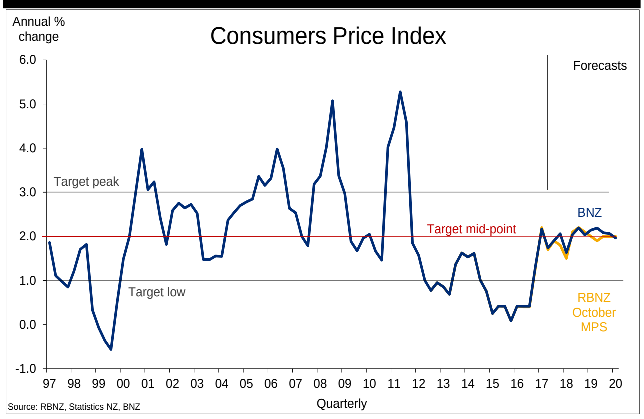
With this backdrop, it is not surprising the RBNZ nudged its modelled interest rate track higher. According to this track, the cash rate still does not hit 2.0% until the March quarter 2020, as was the case in the August MPS. But the cash rate does edge 10 basis points higher in the June quarter of 2019, to 1.9%, implying that a rate increase could happen earlier than previously forecast. Moreover, with the addition of an extra quarter's forecast, the RBNZ has put a second rate hike into its forecast track by Q4, 2020.

These are not major shifts but there is definitely a signalling change going on here which intimates that the RBNZ is now more hawkish than was previously the case. Importantly, from our perspective, it is a slight nod that the chance of a rate hike is now greater than the chance

Pre MPS inflation comparison



Post MPS inflation comparison



of a rate cut. This is different to the symmetrical risk espoused previously.

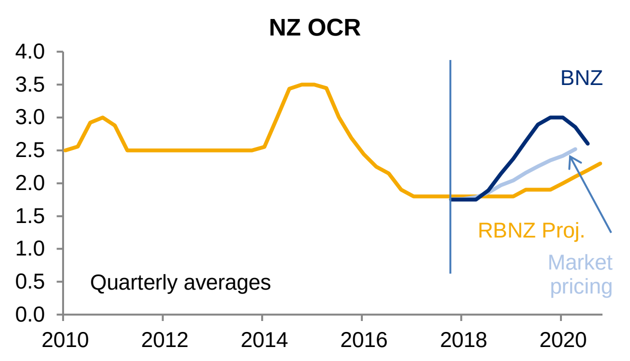
In today's statement, the RBNZ acknowledged the downside risks to its activity forecasts that have eventuated via a weaker housing market and lower residential construction than had been assumed. However, the impact of this on growth (and inflation) is offset by looser than anticipated fiscal policy (read: a change of Government). Importantly, the RBNZ now has this much weaker outlook for the broader housing sector built into its forecasts so the risk that it is forced to lower its inflation expectations due to a weakening housing market is reduced.

As we had expected, the Bank has taken into consideration some of the announced government policies into its forecast process. These assumptions could yet prove incorrect but they simply had to be made. The RBNZ says that it has made assumptions about the following:

- new government spending;
- the KiwiBuild programme;
- tighter visa requirements; and
- increases in the minimum wage.

On balance, the Bank has assumed that total fiscal relaxation has added 0.5% per annum to GDP growth. This has largely been offset by a weaker private sector demand profile so does not result in more pressure on the output gap. However, it is likely that the specifics of the policy, namely the proposed increase in minimum wage, will be putting upward pressure on inflation relative to previous expectations. Moreover, the Bank has only allowed for the direct effects of the minimum wage increase when there will almost certainly be significant flow on impacts.

Interest rate outlook



Source: BNZ, Bloomberg

The Bank, for the first time in a very long time, has stated that it is relaxed about the level of the currency. Indeed, Governor Spencer went so far as to say that the currency is broadly at fair value. This was backed up by the fact that the Bank has left the TWI flat at 73.5 right through its forecast horizon. Following today's MPS the NZD is marginally higher at 74.2, up from 73.7 immediately prior to the release of the MPS.

As today's statement was largely in line with our expectations, our forecast rate track is unchanged. We still believe inflationary pressures will prove higher than anticipated and that the Bank will end up raising interest rates in the second half of 2018 but, equally, we can understand that given the degree of uncertainty that prevails the Bank is not likely to formally suggest such a move any time soon. We would, however, expect each statement from here on in to get progressively more aggressive.

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The full text of today's RBNZ OCR Review –

Official Cash Rate unchanged at 1.75 percent

Statement by Reserve Bank Governor Grant Spencer:

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.

The exchange rate has eased since the August Statement and, if sustained, will increase tradables inflation and promote more balanced growth.

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.

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.

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.

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.

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

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