28 September 2017

Frank Spencer

- **RBNZ OCR and language unchanged, as expected**
- **Albeit as Spencer softens dig at "high" NZD**
- **RBNZ view of falling inflation up for debate now**
- **Post-election bidding for even greater fiscal stimulus**
- **But how might the business sector be impacted?**

Acting RBNZ Governor, Grant Spencer, was reasonably frank at his first OCR review this morning. Nothing material had changed since the August Monetary Policy Statement (MPS). And so it was best to carry on with much the same messages, along with an unchanged cash rate of 1.75%. This was widely anticipated, certainly by local commentators.

The fact the NZD came off a little did suggest, however, that some folk saw a risk of the Bank starting to tether itself a little to the global tide toward removing stimulus. While this global tide is entirely relevant, in our opinion, we still believe the Reserve Bank of New Zealand will do its level best to resist it for the next while.

With a steady cash rate confirmed, a look at the Bank's one page of text showed that the vast majority of it was a word-for-word repeat of the August MPS front-sheet. Nevertheless, there were some minor changes and additions worth discussing.

For example, in saying that a lower New Zealand dollar "would help" to increase tradables inflation and deliver more balanced growth – compared to Wheeler's August phrasing of a lower NZD being "needed" – Spencer softened the Bank's dig at the currency's heights. But then this also seemed acknowledgement that the trade-weighted exchange rate has come off a few per cent since the August MPS was being put together. With all of this, we can imagine the Bank's surprising saber-rattling at the last MPS, about potential for FX intervention, has also done its dash for the meantime.

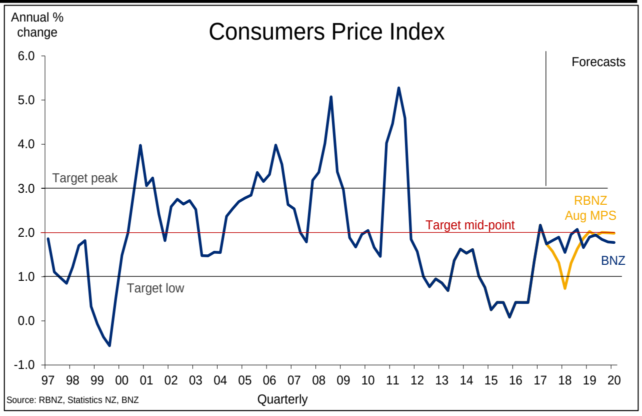
The fact of the matter is that, at about 76.2 this morning, the TWI is 2.2% weaker than the Bank assumed it would average in the December quarter. With this, and the recent strength in commodity prices (including a rebound in global oil prices), we were a little surprised to see the Bank reiterate this morning that "Headline inflation is likely to decline in coming quarters". We believe this view is subject to more debate now.

In the least, annual CPI inflation looks unlikely to subside as much as the RBNZ forecast in its August MPS. This had inflation slumping to 0.7% by the March quarter of 2018. We anticipate 1.5%. Sure, even ours is strictly a "decline" from the 1.7% pace registered in Q2 2017. But we actually expect annual CPI to first nudge up to 1.8% in Q3 then to 1.9% in Q4 – aided by the recent rebound in local petrol prices.

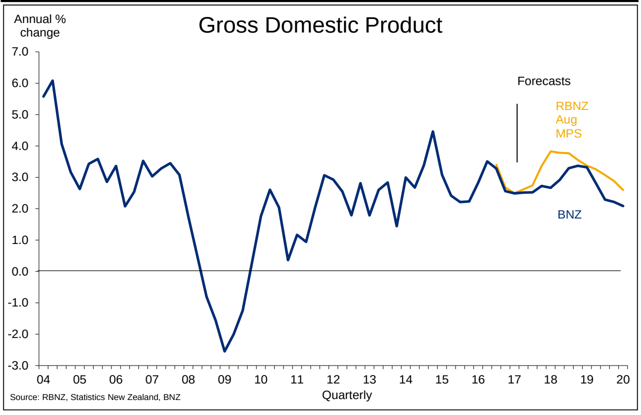
The Bank's words on GDP were also interesting, even intriguing. Of course, confirming that "GDP in the June quarter grew in line with expectations…" in the context of it expanding 0.8% versus August MPS expectation of 0.9%, simply made clear that the miss was the non-issue everyone believed it to be. In this the Bank did not take the opportunity to hint at further frustration that GDP continues to fall shy of the mark (as it had over prior quarters).

Following on from this, the Bank mentioned that "Growth is projected to maintain its current pace going forward" whereas the August MPS said "Growth is expected to improve going forward". Perhaps this simply reflects the fact Q2 GDP picked up to a quarterly pace of 0.8%, and it is this that the Bank expects to be maintained? But if the RBNZ was instead referring to annual rates of growth, then it could be trying to tell us that it's in the process of

Declining?



Overly Optimistic



National Australia Bank

reducing the strength of its GDP forecasts. Recall that these were pushing close to 4% y/y in the first half of 2018.

Broadly speaking, we continue to believe the Bank's last set of GDP growth forecasts looked a bit heroic (along with the Treasury's, we might add).

There was another hook in the Bank's GDP commentary this morning. New text saying "While exports recovered, construction was weaker than expected" might have otherwise have passed as just a nod to composition. However, the latter part of it reminded us of the downside scenario in the August MPS. This, recall, was around building activity and capacity utilisation coming off the boil, such that the industry would not provide as much of a boost to inflation, as it relates to the CPI.

But to concentrate on one particular thread, would be to lose sight of the fact there is much still moving around for the RBNZ – positive and negative. With this there remains a strong sense, from the NZ central bank, that it's very much in a holding pattern on the OCR until it can see a strong case for changing it.

Even with respect to the recent election outcome, there remain questions as to what it means for monetary policy. And this is not just because we don't have a strong inkling as to how the next government, and its agreed-to policy, is going to look.

To be sure, on top of the "spending wars" that erupted during the election campaign, coalition negotiations would seem to encourage a bidding war for even more fiscal stimulus than the Budget already set out. How this will all fit within fiscal responsibility, we have to wonder?

In this there was a reminder that the May Budget appeared to be important in holding the August MPS forecasts up, when many folk saw a risk of the Bank moving to an easing bias at that juncture. The higher than expected exchange rate, at that time, and under-shooting GDP, were just some of the arguments in this direction.

Nonetheless, it's not just the degree of fiscal stimulus we might now be in for, but the form of it. For example, our current economic forecasts are based on the tax cuts the previous government legislated to begin 1 April 2018. If there is instead ensuing legislation to lift the income tax back up (more precisely, the tax thresholds back in) then we will need to know what might fill the gap, and when.

We also have to consider how the new government, and its policies, will influence the private economy, notably in business. For this the sentiment surveys taken after the government is finally confirmed will be of high importance.

With this morning's OCR review passing with little incident, we still expect the RBNZ to begin reducing its cash rate stimulus around August next year. This is even though there is strong case for Bank starting this process sooner, in our view.

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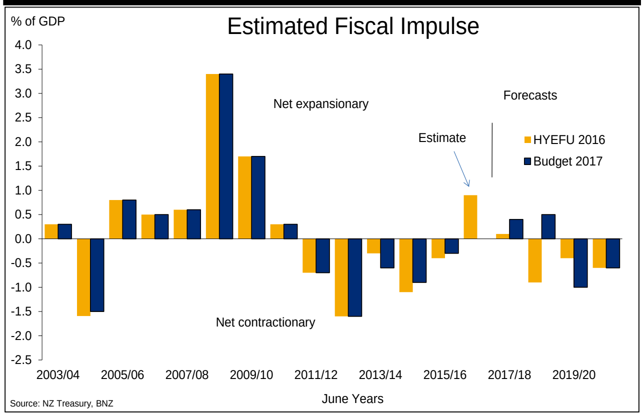
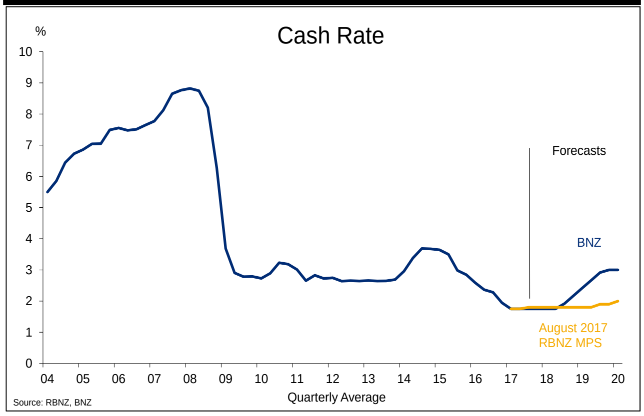
And the Rest



Pressure Building



Please see next page for full text of today's RBNZ OCR Review

The full text of today's RBNZ OCR Review – Official Cash Rate unchanged at 1.75 percent

Statement by Reserve Bank Acting Governor Grant Spencer:

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 1.75 percent.

Global economic growth has continued to improve in recent quarters. However, inflation and wage outcomes remain subdued across the advanced economies and challenges remain with on-going surplus capacity. Bond yields are low, credit spreads have narrowed and equity prices are near record levels. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.

The trade-weighted exchange rate has eased slightly since the August Statement. A lower New Zealand dollar would help to increase tradables inflation and deliver more balanced growth.

GDP in the June quarter grew in line with expectations, following relative weakness in the previous two quarters. While exports recovered, construction was weaker than expected. Growth is projected to maintain its current pace going forward, supported by accommodative monetary policy, population growth, elevated terms of trade, and fiscal stimulus.

House price inflation continues to moderate due to loan-to-value ratio restrictions, affordability constraints, and a tightening in credit conditions. This moderation is expected to continue, although there remains a risk of resurgence in prices given population growth and resource constraints in the construction sector.

Annual CPI inflation eased in the June quarter, but remains within the target range. Headline inflation is likely to decline in coming quarters, reflecting volatility in tradables inflation. Non-tradables inflation remains moderate but is expected to increase gradually as capacity pressure increases, bringing headline inflation to the midpoint of the target range over the medium term. Longer-term inflation expectations remain well anchored at around two percent.

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

Note: Following the departure of Graeme Wheeler, the Reserve Bank's policy making Governing Committee now comprises: Acting Governor Grant Spencer, Deputy Governor Geoff Bascand, and Assistant Governor John McDermott.

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