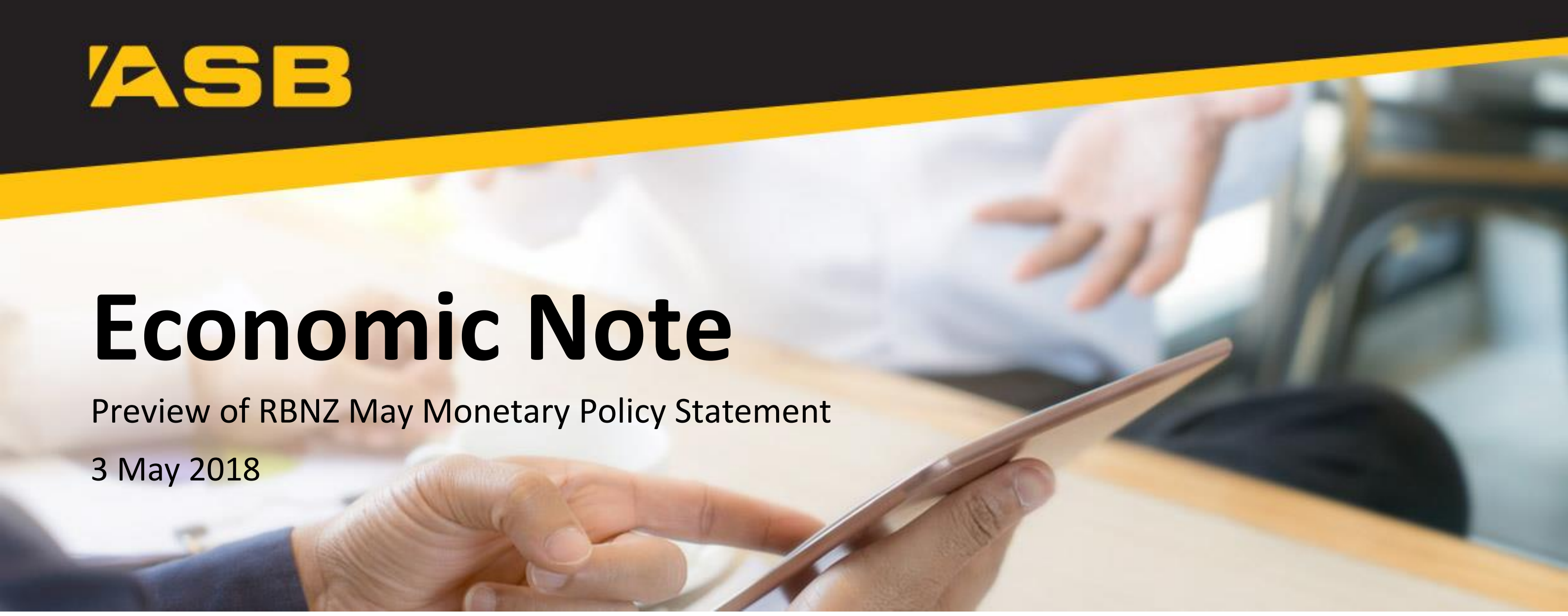

Economic Note

Preview of RBNZ May Monetary Policy Statement

3 May 2018

Rowing with a new Orr

- Economic data suggest little change to the RBNZ's outlook, though the inflation outlook could be slightly lower.
- Decent employment conditions also suggest no need for the OCR to change for some time yet.
- We don't expect the new PTA or new Governor to materially shift the RBNZ's monetary policy outlook.

We expect the RBNZ to keep the OCR on hold on Thursday 10th and retain a neutral stance. Developments since the March OCR Review tilt marginally towards more caution over how long it will take to sustain inflation comfortably around the 2% inflation target mid-point. **It is possible that the RBNZ defers slightly the timing of its forecast OCR increases.** But recent developments are well within the range of shifts the RBNZ has absorbed without tinkering with its OCR view.

This is the first OCR decision since new Governor Adrian Orr started along with the new Policy Targets Agreement (PTA) that includes the employment objective. And that will make this Statement the most keenly read one since the RBNZ signalled the end of its last easing cycle. **Employment conditions are good and don't indicate the RBNZ needs to relax its monetary policy stance.** And, although it is always possible Governor Orr will steer the RBNZ slightly differently to his predecessors, **we don't expect him substantially influence the RBNZ's current take on the appropriate direction for monetary policy.** But we do expect Governor Orr to continue bringing transparency to the RBNZ's internal prognostications.

Events all still point convincingly to the OCR remaining low until at least the second half of 2019.

Inflation influences mixed

All up, influences on the inflation outlook are pretty mixed, suggesting little need for much change in the RBNZ's medium-term inflation forecasts and OCR outlook. Developments suggesting added inflation are:

- Stronger non-tradable inflation in the Q1 CPI indicates some emergent pressure;
- A generalised lift in commodity prices, including to dairy prices;
- Higher petrol prices in the near term, which are likely to prevent a fall in inflation expectations, and higher petrol prices in the longer term through the Auckland regional fuel tax and nation-wide excise tax increases;
- Potential for a greater amount of infrastructure investment to be included in the RBNZ's forecasts;
- The NZD Trade Weighted Index, at around 73.5, is around 2% lower than what was assumed in the February MPS. If this gap holds, all else equal, it would add around 0.2 percentage points to the Bank's forecasts for annual CPI inflation over the next 12 months;
- Strong trading partner activity forecasts (and less sabre-rattling over trade);
- Persistence in regional house price growth (although a recent RBNZ Discussion Paper suggests wealth effects from house price growth will be muted).

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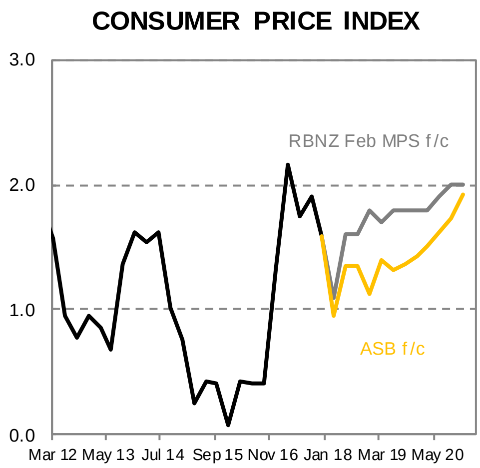
And, to complete the exercise in two-handedness, the factors suggesting less inflation pressure are:

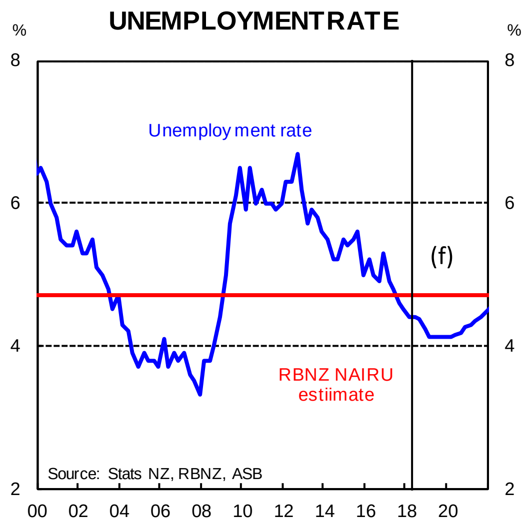
- Higher wholesale interest rates, with recent increases the equivalent of a 25bp OCR hike. Although there has been some pass-through to business lending rates, mortgage rates have yet to be affected;
- Business confidence, as measured by the ANZ monthly survey, remains low and fell slightly in the April survey. Although business confidence is typically lower under a Labour-led government, there is an increased risk that near-term growth is softer than we and the RBNZ have been assuming. Consumer confidence also dipped in April, with overall confidence measures pointing to a period of sub-trend growth;
- Construction cost inflation, which was lower than expected in Q1 despite widespread views that the sector is capacity constrained.



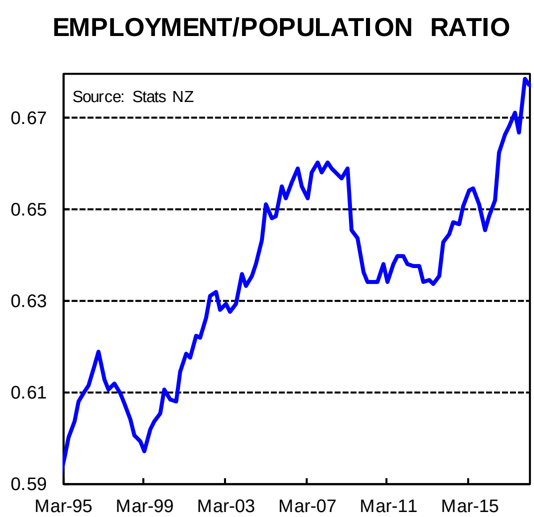
All up, the risks are skewed to the RBNZ pushing out the timing of its forecast OCR increase. Compared to the RBNZ's February forecasts, we have slightly lower growth and inflation forecasts. Much of the difference in our respective inflation outlooks is through our weaker tradable CPI inflation outlook, a reflection of our more bullish outlook for the NZ dollar. But the implications are that the RBNZ is likely to tweak down its assessments of growth and inflation pressure, which flags potential for the RBNZ to push out its forecast OCR increases from the current late 2019 view.

Employment and the new PTA

The RBNZ is now required to "contribute to supporting maximum sustainable employment within the economy". We expect the RBNZ to start devoting part of the MPS to assessing the state of the labour market.



The Q1 labour market figures just out show a picture of good health, though with scope to improve a touch further. The unemployment rate is 4.4%, lower than the RBNZ's 4.7% mid-point estimate of the Non Accelerating Inflation Rate of Unemployment (or NAIRU), a fancy way of describing the unemployment rate below which wage inflation pressures start to pick up (and translate into firming domestically-generated CPI inflation). The employment rate (share of working age population in work) is just below 2017Q4's high in 3 decades of records. The labour force participation rate (share of working age population in work or seeking work) is similarly only marginally below its record high.



Together, **these measures suggest no need to cut interest rates to further contribute to the RBNZ's employment objective. Nor do they argue for higher interest rates right now**, particularly while wage inflation remains low. But over time, if anything, further tightness in the labour market would completely clear the way for the RBNZ to lift the OCR in response to increasing inflation pressures.

Embarking a new Orrsman

Given this is Adrian Orr's first Monetary Policy Statement as Governor, more tea-leaf reading than usual will go into the Statement and forecasts for any signs that the Governor is

steering the RBNZ's assessment in a different direction. The modest change in underlying economic conditions relative to the preceding OCR decision is within the bounds of past shifts from one decision to the next, and doesn't suggest much need for any material change in stance.

Accordingly, **we don't expect any material changes from the new hand on the steering oar**. For one, the RBNZ's concluding line of its recent policy assessments remains just as relevant, even with the added employment objective: "Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly." Furthermore, we don't see much relevance in debating whether Adrian Orr is a 'hawk' or a 'dove': we expect that his monetary policy views will be guided by the collective views of the Economics Department and senior leaders. **But we acknowledge that leader-led change is a possibility.** Some of Adrian Orr's attributes are his ability to see the big picture rather than get lost in micro details, as well as a healthy degree of pragmatism over monetary policy's role and limitations.

One thing we can be quite confident in is that Adrian Orr will spend a lot more time engaging with the public. In the first 5 weeks of his term it already feels like he has given more media interviews than the previous permanent Governor gave over his whole 5-year term. More frequent communication might increase the incidence of miscommunication or misinterpretation, merely through more occasions existing. But we expect that a much higher level of transparency will leave financial markets and the broader public more aware of what the RBNZ is thinking and why. In this, Adrian Orr should prove to be the opposite of Alan Greenspan, former US Federal Reserve Chair, who once said "I guess I should warn you, if I turn out to be particularly clear, you've probably misunderstood what I said".

March 2018 RBNZ OCR media release

Statement by Reserve Bank Acting Governor Grant Spencer:

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

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.

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.

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.

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.

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