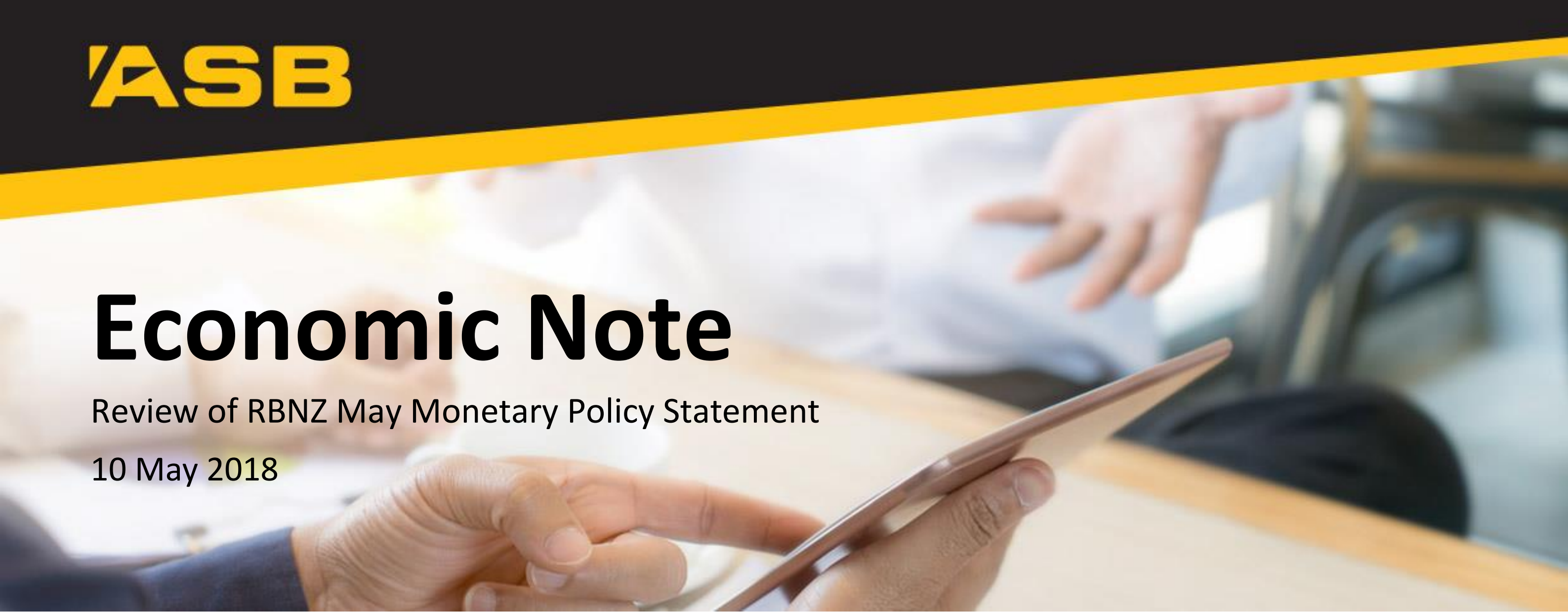

Economic Note

Review of RBNZ May Monetary Policy Statement

10 May 2018

Orrsome start

- OCR on hold at 1.75% as widely expected.
- The policy bias is very explicit: “The direction of our next move is equally balanced, up or down. Only time and events will tell”. We see the intended message as very similar to the previous policy assessments.
- The RBNZ substantially changed the way in which it lays out the Monetary Policy Statement, as it flagged earlier in the week. The result: greater clarity and a swiftly digestible message.
- The RBNZ’s OCR forecasts changed only slightly: the point at which the OCR starts rising was pushed out a quarter and is still consistent with a late 2019 start to OCR increases. The forecast end point in 2021 remained in line with the February MPS forecasts.

As was widely expected, the RBNZ left the Official Cash Rate unchanged at 1.75% in an unanimous decision amongst the deciding committee. The RBNZ delivered a balanced risk assessment, noting that the “direction of our next move is equally balanced, up or down”. The Bank also highlighted that this assessment would be conditional on future events by noting “Only time and events will tell”. **The RBNZ’s OCR outlook was little changed from February’s Statement.**

Importantly the statement provided both upside and downside scenarios. On the downside, the run of low inflation could be more persistent for longer than the RBNZ anticipates. On the upside inflation could pick up faster than expected if price-setting behaviour becomes more forward looking. Upcoming minimum wage increases are another upside risk to inflation, as higher wages could cause firms to raise prices by more than assumed.

The Statement started delving into understanding what Maximum Sustainable Employment is. At this point, **the state of employment is not materially impacting the OCR outlook**.

To us the **highlight of the Statement was the shift to making the RBNZ’s messages clearer and readily understandable**. We give the RBNZ top marks for the shift.

We continue to expect the RBNZ to remain on hold until at least August 2019.

Economic outlook: not much change

The NZ economy is still adjudged to have a solid growth outlook, reflecting widespread supports, including the robust global growth, government spending, still-strong net immigration, the historically-high Terms of Trade and still-supportive monetary conditions. Over the forecast, stimulatory monetary policy is needed to drive GDP growth above its potential rate so as to generate a pick-up in capacity pressure, further increases in employment, and a rise in inflation.

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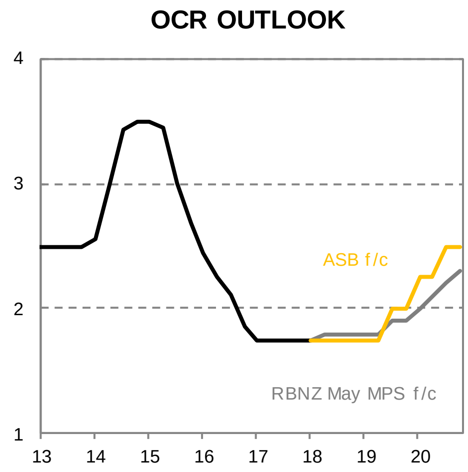
The growth outlook for the March 2018 (2.8% yoy) and 2019 (3.1% yoy) and 2020 years (3.3% yoy) was marginally weaker than that projected in the February MPS (3.2% yoy, 3.5% yoy, and 3.4% yoy respectively). By construction, projections for CPI inflation were around 2% by the end of the projection period. Compared, to the February MPS, however, forecasts for annual CPI inflation were shaded down to 1.6% by the end of 2018 (1.8% in February), to 1.7% for 2019, with Q4 2020 the first quarter in which CPI inflation hits 2%. Our projections continue to suggest some downside risks to the RBNZ forecasts.

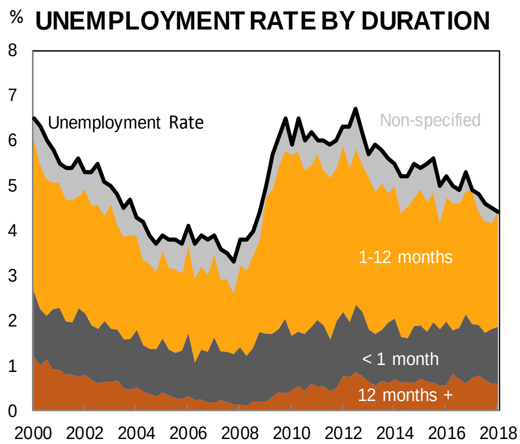
The OCR forecast track was marginally pushed out relative to the February MPS, with rates moving up in Q3 of 2019 (previously 2019Q2). There were 50bps of OCR hikes over the published projection period, with an endpoint of 2.4% that ended in mid-2021.

Comments on the housing market were kept to a minimum, reflecting the RBNZ's confidence that the inflation and financial stability risks posed by the housing market were under control. The policy assessment (and media conference) made little mention of the NZD, signalling the RBNZ's apparent comfort with its current level. The Trade Weighted Index projection showed little change relative to the February MPS.



Assessing Maximum Sustainable Employment

Given its increased focus, the Statement devoted considerably more content to the labour market. The RBNZ did note that the labour market has tightened over the past five years, with a range of indicators suggesting that employment is close to its maximum sustainable level. However, the RBNZ notes this assessment as being highly uncertain. Over the projection, employment growth is expected to slow, but remain higher than growth in the working age population. As a result, the employment rate is expected to edge slightly higher over the forecast, with the unemployment rate troughing in the low 4's, which is similar to our forecasts.



Box C of the Statement provided comprehensive coverage of the labour market, covering in detail what the RBNZ adjudged to mean maximum sustainable employment (MSE) as per the new Policy Targets Agreement. The RBNZ noted this was analogous to the concept of potential output, which is a core part of the RBNZ's existing flexible inflation-targeting framework. MSE consists of a number of indicators depending on levels of employment, the employment rate, the underemployment rate, underutilisation, the potential labour force, labour force participation and the unemployment rate (with particular focus on the unemployment rate for those out of work for between 1 and 12 months). The RBNZ's estimates of the Non-Accelerating Inflation Rate of Unemployment (NAIRU) currently range from 3.5% to 5.3%, with the current unemployment rate of 4.4% in the middle of this.

Our take: two thumbs up for transparency and clarity

The new Governor, Adrian Orr, came into the role with the intentions of bringing greater transparency to the RBNZ's deliberations and of improving its communication style. He has made a mark through substantially changing the way in which the Monetary Policy Statement presents the RBNZ's views. The overall message from the statement is very similar to the previous Statement's, even with the new Policy Targets Agreement. But the presentation is now being done in a way that makes the RBNZ's messages much clearer and less vulnerable to misinterpretation. Importantly, the RBNZ's thinking is going to be much more readily digestible by a broader range of people. We give Adrian Orr and the RBNZ plaudits for this change.

In his first media conference as Governor, Adrian Orr responded to questions in a plain-speaking and readily understandable way, with some pockets of humour sprinkled in. Some key takeaways from his comments:

- There is uncertainty over assessing the extent of spare capacity in the goods and labour markets;
- And further uncertainty over the linkages of these capacity constraints to inflation;
- Given these uncertainties, the fairly neutral starting point, and the usual uncertainties over the outlook, the neutral assessment for the OCR is prudent for now.

One of the key things Adrian Orr wants to change about the RBNZ is its style of communication, with the intention of reaching a wider audience than "a few retail bank economists". He wants the NZ public to become more aware of what the RBNZ actually is, with the aim boosting New Zealanders' financial literacy. As one early example, the RBNZ has created a pictorial showing the factors influencing current monetary policy considerations – it is worth a look (scroll down).

Market reaction

The neutral OCR policy assessment and modest pushing out of the published OCR track was generally interpreted to be dovish by markets. The NZD initially dipped about 30 points versus the USD and is current 40 points lower. The NZD TWI is about 40 points lower than immediately prior to the RBNZ decision. NZ interest rates fell. Yields on the bellwether 2-year swap rate initially dipped 2bps, but had fallen a further 6bps by the end of the RBNZ media conference. Falls for other tenors were more modest.

Key Rates	8:55am	9:15am	10:45am
NZD/USD	0.6983	0.6950	0.6940
NZD/AUD	0.9358	0.9309	0.9301
NZD/EUR	0.5892	0.5864	0.5855
NZD/JPY	76.62	76.25	76.16
NZD/GBP	0.5154	0.5129	0.5122
NZ TWI	73.49	73.12	73.03
NZ 90 day Bank Bill	2.05	2.05	2.05
NZ 1 year swap rate	2.13	2.10	2.10
NZ 2 year swap rate	2.28	2.26	2.20
NZ 3 year swap rate	2.45	2.42	2.41
NZ 5 year swap rate	2.76	2.72	2.73

May 2018 RBNZ OCR media release

Statement by Reserve Bank Governor Adrian Orr:

Tena koutou, katoa, welcome all.

The Official Cash Rate (OCR) will remain at 1.75 percent for some time to come. The direction of our next move is equally balanced, up or down. Only time and events will tell.

Economic growth and employment in New Zealand remain robust, near their sustainable levels. However, consumer price inflation remains below the 2 percent mid-point of our target due, in part, to recent low food and import price inflation, and subdued wage pressures.

The recent growth in demand has been delivered by an unprecedented increase in employment. The number of willing workers continues to rise, especially with more female and older workers choosing to participate. Likewise net immigration has added to the supply of labour, and the demand for goods, services, and accommodation.

Ahead, global economic growth is forecast to continue supporting demand for New Zealand's products and services. Global inflation pressures are expected to rise but remain contained.

At home, ongoing spending and investment, by both households and government, is expected to support economic growth and employment demand. Business investment should also increase due to emerging capacity constraints.

The emerging capacity constraints are projected to see New Zealand's consumer price inflation gradually rise to our 2 percent annual target.

To best ensure this outcome, we expect to keep the OCR at this expansionary level for a considerable period of time. This is the best contribution we can make, at this moment, to maximising sustainable employment and maintaining low and stable inflation.

Our economic projections, assumptions, and key risks and uncertainties, are elaborated on fully in our Monetary Policy Statement.

Meitaki, thanks

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