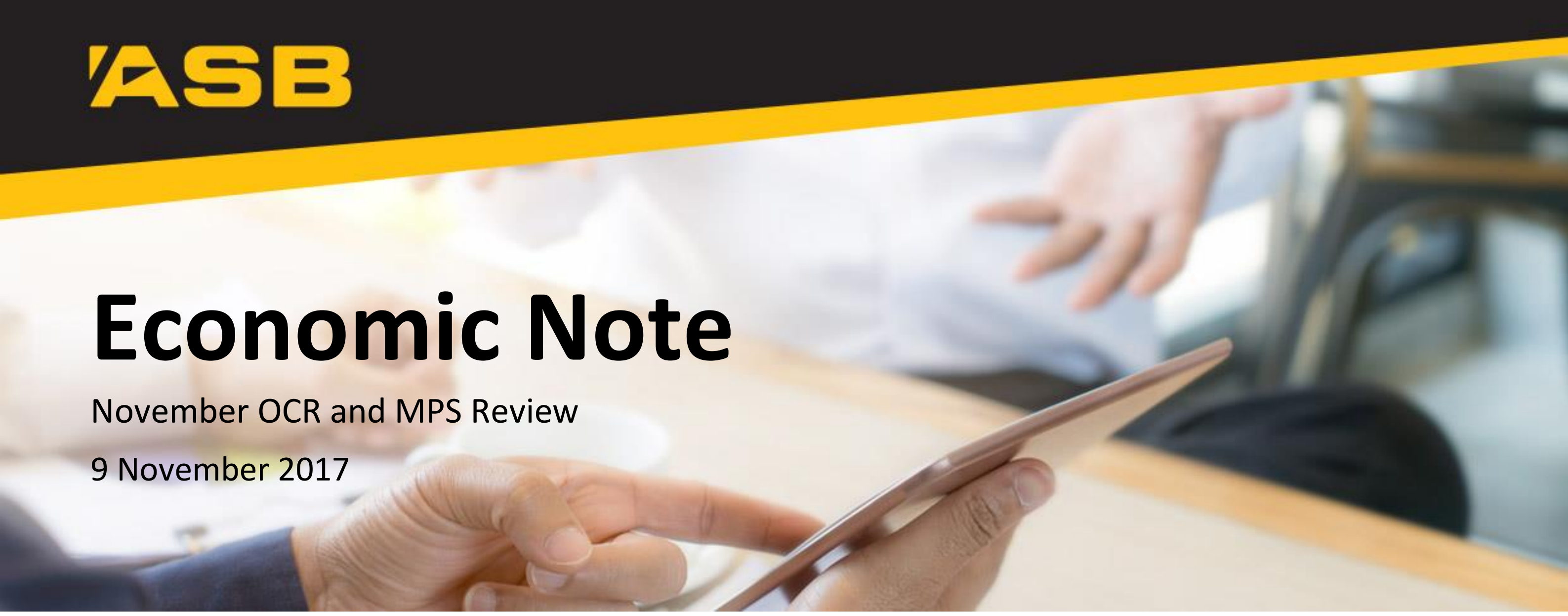


Economic Note

November OCR and MPS Review

9 November 2017

Swings and roundabouts

- OCR on hold at 1.75% as universally expected with the long-held neutral stance retained.
- Estimates of some key government policy changes have been factored into the forecasts.
- Despite adding in these changes, the RBNZ's OCR forecasts changed only marginally.

Summary

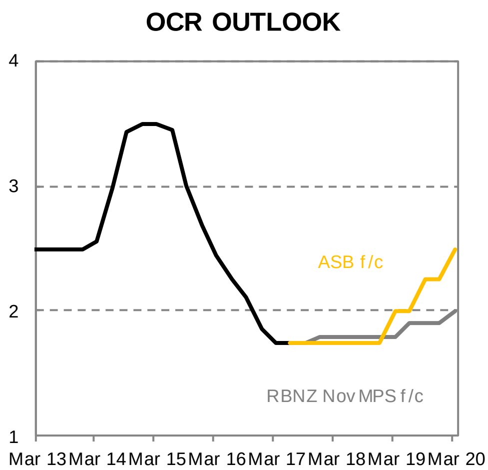
The Reserve Bank of New Zealand (RBNZ) kept the Official Cash Rate (OCR) on hold, along with its neutral policy outlook. Although the inflation outlook is now higher, the RBNZ's outlook for the OCR has barely changed.

The key development with the Monetary Policy Statement (MPS) is the inclusion of assumptions around some key government policy changes. The assumptions focus on policy shifts that are likely to have the most significant impact on the inflation outlook and, on a net basis, will be inflationary.

Very importantly, the inclusion of these policy assumptions has shifted the RBNZ's OCR outlook very little. That may be because the RBNZ had appeared to already trim its growth outlook back in September. Hence, the inclusion of added government stimulus has since boosted growth back in line with August's projection. Looking ahead to the RBNZ's deliberations next year, there will be further forecast fine-tuning to account for the Government policy changes as more detail is known. But a big Government-related lurch in the RBNZ's policy assessment seems unlikely. We remain comfortable with our view that the RBNZ will lift the OCR in early 2019.

Factoring in the new Government

In accounting for the change in Government the RBNZ appears to have done as much as it could, considering the current lack of detail. 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 RBNZ notes, though, that the impact of these policies remains very uncertain. We had not expected the RBNZ to be as explicit as it has been in gauging the impacts of Government policy changes. Nonetheless, these estimates were largely in line with our expectations, with higher government spending and increases to the minimum wage adding to inflationary pressure at the margin.



The RBNZ has worked in the Government's Families Package in place of the National Government's tax cuts, with the

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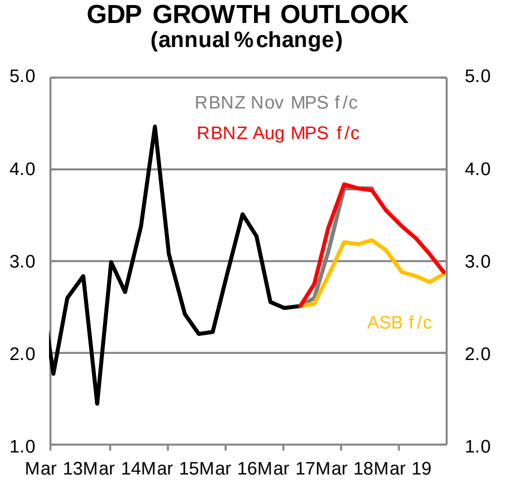
Please refer to the important disclosures at the end of this document.

new package still supporting household spending. The RBNZ has factored in a faster fall in net migration, but notes that NZ and Australian flows are not affected. The RBNZ has incorporated the increased minimum wage and notes this is likely to spill over into stronger wage increases for workers in higher wage brackets as well. The RBNZ notes the higher labour costs may impact labour demand and hiring intentions, and has incorporated a modest impact. Offsetting that impact though, appears to be the tightening up of migration, as the RBNZ's unemployment rate outlook is nonetheless lower than its August outlook.

Growth trimmed marginally

As was expected, the Bank, trimmed its near-term growth forecasts for the New Zealand economy, although the shift was modest considering the weakening in business confidence and other forward-looking indicators. Growth is expected to average 0.8% per quarter over the second half of 2017 versus the close to 1% quarterly increases assumed in August. Momentum, however, is expected to strengthen in the first half of 2018, before moderating to closer to trend rates thereafter. Stimulatory monetary and fiscal policy, continued population growth and high Terms of Trade are expected to support GDP growth and a rise in capacity pressure. Global growth forecasts were revised up, though only modestly.



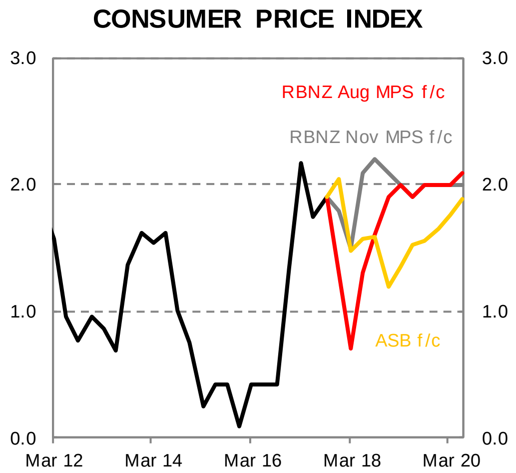
Housing down and out?

The RBNZ has softened its house price outlook relative to recent statements. Rather than noting the risk of resurgence in house price inflation, the RBNZ stated that "low house price inflation is expected to continue." The new Government's housing policies will impact investor demand and reinforce the reduced risk of a house price rebound.

The cooling of the market opens the door to for the RBNZ to consider removing the Loan to Value ratio (LVR) lending restrictions. The upcoming Financial Stability Report will outline the RBNZ's criteria for relaxing/removing these restrictions. The Government notes these restrictions will be eased in a gradual manner.

NZD assumed to stay down

The RBNZ noted that the recent fall in the NZD would support tradable inflation over the coming year. Further, the RBNZ believes that the Trade Weighted Index will remain at its current level of 73.5 over the remainder of the forecast horizon, based on a judgement that the fall was due to reduced offshore demand for NZ dollar assets. We do see the risk that the NZD recovers some of its recent election-related losses as structural factors such as the high Terms of Trade will continue to be NZD supportive.



Inflation outlook higher

The RBNZ has revised its headline inflation forecasts higher over the next 12-18 months. The new forecasts take into account the lower NZD outlook and the inflationary impacts of the new government initiatives the RBNZ has incorporated.

Future policy target changes

As outlined earlier this week, the new Government is instigating a two-stage review of the Reserve Bank Act. We expect key recommendations to include adding a dual mandate, including employment alongside price stability. A shift to a formal committee for policy decisions is highly likely.

Provided any employment target is a worded one rather than an explicit numerical target, we see few implications for monetary policy operations. RBNZ comments during a media conference suggest a similar conclusion. But the target changes will be an added consideration next year for the RBNZ, along with the Government policy changes the RBNZ is already starting to factor in. You can find all the details on how the RBNZ's policy target could change in our Note.

November 2017 MPS RBNZ media release

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.

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.

Side by side

November 2017 MPS	September 2017 OCR
OCR Decision	*OCR Decision*
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 Outlook	Global Outlook
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.	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.
Exchange rate	*Exchange rate*
The exchange rate has eased since the August Statement and, if sustained, will increase tradables inflation and promote more balanced growth.	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.
Economic Activity	*Economic Activity*
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.	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.
Housing market	*Housing market*
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	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.
Inflation	*Inflation*
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.	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.
Policy Outlook	*Policy Outlook*
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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