Weekly Commentary

3 April 2018

Dual meaning

The Reserve Bank's new Policy Targets Agreement (PTA) reflects the Government's desire for employment to be considered as part of monetary policy decision-making. The responsibility now lies with the Reserve Bank to figure out how to put this loosely worded objective into practice.

Last week, RBNZ Governor Adrian Orr and Finance Minister Grant Robertson signed a new PTA specifying that:

"The conduct of monetary policy will maintain a stable general level of prices, and contribute to supporting maximum sustainable employment within the economy."

The PTA goes on to define a numerical target for price stability, which is broadly unchanged from the previous version: future inflation will be kept between 1-3% over the medium term, with a focus on keeping it near the 2% midpoint. In contrast, there is no numerical target or definition of what constitutes maximum sustainable employment.

The lack of an employment target is appropriate, and is in line with the approach taken by other 'dual mandate' central banks such as the Reserve Bank of Australia and the US Federal Reserve. Monetary policy can affect labour market outcomes in the short term, but in the long run the unemployment rate is determined by structural factors that are beyond the control of the RBNZ. What's more, the sustainable rate of unemployment is inherently unobservable, and may change over time.

While the lack of a fixed target for employment is appropriate, the RBNZ will still need to make some judgement calls about the state of the labour market. The fact that the sustainable rate of employment is unobservable is not in itself a strike against it. Economic models are riddled with unobservable variables such as the 'neutral' interest rate, the expected rate of inflation, or the 'fair value' of the exchange rate. The best that policymakers can do is to make assumptions about these variables, and to be open to reviewing those assumptions as new information comes in.

A recent RBNZ research note estimated a non-inflationary unemployment rate of 4.7%, a number that was widely quoted in the media and indeed by the RBNZ itself in the February Monetary Policy Statement. However, the story is not so simple. This was only a point-in-time estimate as at the September 2017 quarter, the most recent data available at the time. The method used by the RBNZ produces a non-inflationary unemployment rate that varies a great deal over time (and often moves in line with the actual unemployment rate). It's quite possible for unemployment to go below this rate in the near term without generating higher inflation, if there are other offsetting forces such as falling import prices.

The RBNZ's research suggests that the long-run 'natural' rate of unemployment, once all of the known shocks to the economy have worked their way through, is closer to 5%. This by no means represents a target level for monetary policy. But if the RBNZ adopts this estimate, then its forecasting model – and the inflation track that it generates – will tend towards this level of unemployment in the long run.

Our view is that, in current circumstances, the new employment objective will make little difference to the RBNZ's behaviour. Today's unemployment rate of 4.5% is

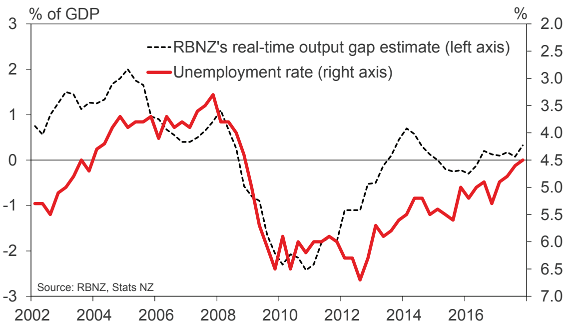
Dual meaning... continued

close to the estimated sustainable long-run rate. Inflation is within the target range (albeit on the lower side), and the RBNZ is forecasting it to stay there in coming years. And the RBNZ already has a great deal of flexibility around how it manages the path of inflation over the medium term. So we agree with the RBNZ that the need for OCR hikes is some time away – further away than the early 2019 hike that the market is pricing in.

That said, there may be circumstances in the future where the employment objective does make a difference to the RBNZ's interest rate decisions. Arguably, there have been times in the past when a dual mandate might have made a difference as well – the Finance Minister has for instance mentioned the 2014 episode, when the RBNZ raised the cash rate by 100 basis points in anticipation of higher inflation, only to start reversing those hikes a year later.

At the time, the RBNZ believed that the economy was running above its non-inflationary potential. With the benefit of more data, the RBNZ now estimates that output was still below potential in 2014. A focus on the labour market might have brought the RBNZ to this conclusion sooner: the unemployment rate was around 5.5% at the time, which is consistent with some spare capacity remaining.

RBNZ output gap vs unemployment rate



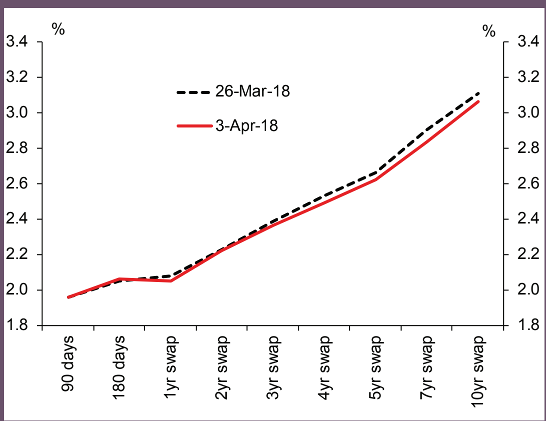
However, the RBNZ's focus is on future inflation. While unemployment may have been on the high side in 2014, the RBNZ was forecasting a return to full employment over the next few years, which would have been associated with a pickup in wage and price pressures. So it's not clear that a focus on employment would have prevented the 2014 rate hikes. However, the RBNZ might have been less aggressive in signalling future rate hikes – initially it thought that it would need to hike the OCR by at least 200 basis points over the next two years.

Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter fixed terms. Three-to-five-year rates seem high relative to where we think short-term rates are going to go over that time. Some lending and deposit rates have been falling recently, so it may be worth waiting to see if there are further modest reductions in fixed-term rates.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates



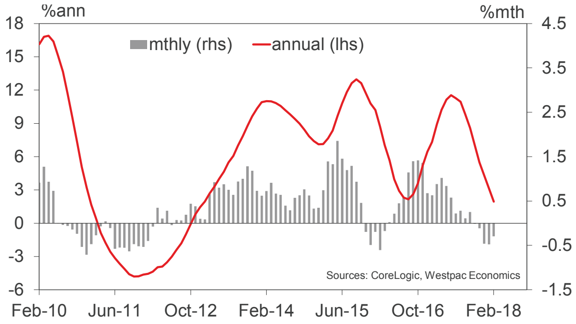
The week ahead

Aus Mar CoreLogic home value index

Apr 3, Last: –0.3%, WBC f/c: –0.2%

- The weak finish to 2017 for Australia's housing markets extended into early 2018. The CoreLogic home value index, covering the eight major capital cities, dipped another 0.3% in Feb to be down 1.3% since Oct. Annual price growth slowed to 2%, from a peak of 11.5% in May and dipping below the previous low in Sep 2016 to be the weakest pace since 2012. The daily index points to further price slippage in March and a 0.2% decline nationally. That would see annual growth dip to below 1%. While there are some hints in the monthly profile that the pace of price declines is moderating, they are far from convincing. The regional detail continues to show a sharper slowdown in Sydney and to a lesser extent Melbourne, both of which had shown much stronger price gains through the upswing. Notably, the milder slowdown in Melbourne looks to have accelerated somewhat in early 2018.

Australian dwelling prices

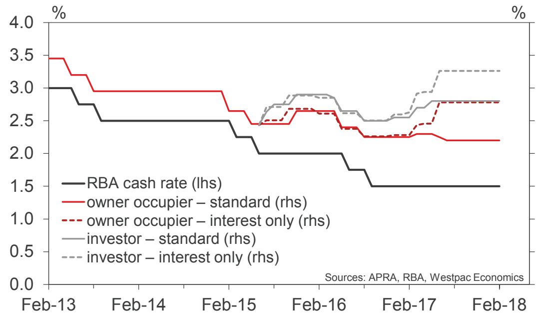


Aus RBA policy decision

Apr 3, Last: 1.50%, WBC f/c: 1.50%,
Mkt f/c: 1.50%, Range: 1.50% to 1.50%

- The RBA will almost certainly hold rates unchanged at its April meeting. Attention will again focus on the Governor's decision statement. In March this reiterated the central line that: "further progress in reducing unemployment and having inflation return to target is expected, although this progress is likely to be gradual". The Governor sounded a little more confident about the outlook for wages growth which "appears to have troughed". However, other comments in the statement and the meeting minutes suggest the Bank may be less confident about its 3¼% growth forecast for 2018. The next official update to the Bank's forecasts is in the May Statement on Monetary Policy. This shift in language – if sustained in April – could be seen as paving the way for a downward revision. Either way, Westpac expects slower growth of 2.7% this year and the cash rate unchanged at 1.5% throughout this year and next.

RBA cash rate and mortgage interest rates

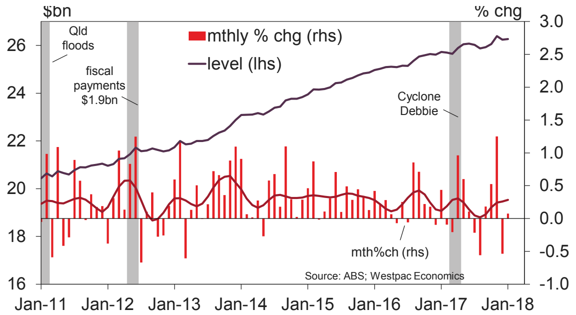


Aus Feb retail trade

Apr 4, Last: 0.1%, WBC f/c: 0.4%
Mkt f/c: 0.3%, Range: 0.2% to 0.7%

- Retail sales posted a disappointing start to 2018 with a 0.1% gain in Jan only partially retracing a 0.5% decline in Dec which in turn followed a solid rebound in Oct-Nov from a weak Q3. Annual growth slowed to a sub-par 2.1%yr. The subdued result comes despite a firmer backdrop for consumer sentiment and suggests the step-up in price competition associated with the launch of Amazon's Australian retail operations late last year remains a restraining factor on nominal sales. Retailers may have fared a little better in Feb. While price competition remains fierce and consumer sentiment softened a touch, retail sector responses to the NAB business survey showed a lift in conditions over Jan-Feb to the second highest reading since late 2015. However, the AiG PSI points to much weaker conditions for retail. On balance we expect Feb to show a 0.4% gain.

Monthly retail sales

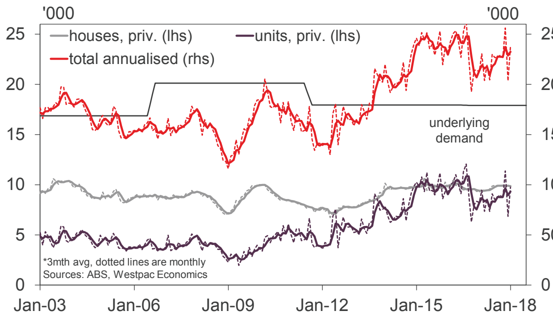


Aus Feb dwelling approvals

Apr 4, Last: 17%, WBC f/c: –4.0%
Mkt f/c: -5.0%, Range: -12.0% to -1.0%

- The January dwelling approvals report came in well above expectations driven by extreme swings in the lumpy 'high rise' segment. Approvals outside of high rise have been more mixed, private detached house approvals down 1.1% but 'mid rise' dwellings up about 15%. Housing finance data continues to point to modest gains in non high rise approvals, albeit with the trend showing signs of softening. High rise is much harder to call. Site approvals continue to point to the segment taking another leg lower after the weakening in the first three quarters of 2017. Note also that despite the big lift in Jan, high rise approvals were coming off a very weak Dec read. On balance we expect total approvals to retrace 4% in Feb but clearly extreme monthly volatility puts significant risks around this estimate.

Dwelling approvals



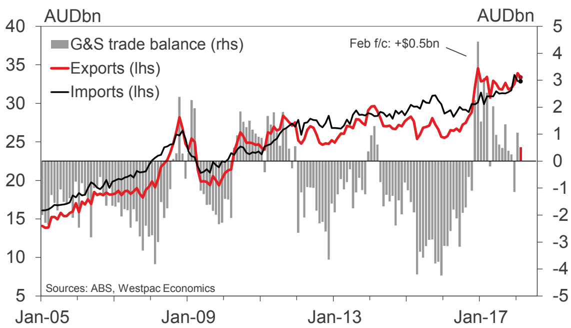
The week ahead

Aus Feb trade balance, AUDbn

Apr 5, Last: 1.1, WBC f/c: 0.5
Mkt f/c: 0.7, Range: -0.3 to 2.1

- Australia's trade account recorded a surplus of $1.06bn in January as exports lifted 4.3%, boosted by a $0.8bn spike in gold shipments. For February, the trade surplus is expected to narrow to $0.5bn, impacted by a pull-back in gold exports. Export earnings are forecast to decline by 1.6%, down $550mn. An expected $0.8bn pull-back in gold is only partially offset by a lift in LNG volumes, on expanding capacity, and a lift in coal shipments. Imports are expected to be unchanged in the month. A weaker currency, down 1.8% on a TWI basis and 0.8% lower against the US dollar, will see the cost of imports rise. However, we anticipate an offsetting moderation in fuel imports following two particularly strong months.

Australia's trade balance



US Mar employment report

Apr 6, nonfarm payrolls, last 313k, WBC 170k
Apr 6, unemployment rate, last 4.1%, WBC 4.0%

- Nonfarm payrolls employment growth has been particularly strong in recent months. Feb posted a 313k gain, and job gains in the prior two months were also revised up by 54k in total. The three-month average stands at 242k, well up on 2017's 182k and 2016's 195k. After such strength, we are due a softer month, and so forecast a 170k gain. We note however that revisions could do the work and allow for another strong outcome above 200k for the month of Mar. Turning to the household survey, had it not been for a jump in participation in Feb, the unemployment rate would have come down to 4.0%. Continued strength in employment will see the threshold attained and breached in coming months. A quick drop below 4.0% is a risk if participation reverses recent gains as employment holds up.

Unemployment rate to push lower

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Tue 3					
Aus	RBA policy decision	1.50%	1.50%	1.50%	On hold. Inflation below band and housing cooling.
	Mar AiG PMI	57.5	–	–	Manuf'g expansion on rising construction & lower AUD.
	Mar CoreLogic home value index	–0.3%	–	–0.2%	Price slippage has carried into early 2018.
	Mar ANZ job ads	–0.3%	–	–	Remains at elevated level.
Eur	Mar Markit manufacturing PMI final	56.6	56.6	–	PMIs likely to soften from historically high levels in 2018.
UK	Mar Markit manufacturing PMI final	55.2	54.8	–	Firmer global conditions are supporting demand.
Wed 4					
NZ	GlobalDairyTrade auction	–1.2%	–	–	Prices expected to soften a little further.
	Mar ANZ consumer confidence	127.7	–	–	Confidence firmed again, following its post–election drop.
Aus	Feb dwelling approvals	17.1%	–5.0%	–4.0%	Skewed by big monthly swings in high rise approvals.
	Feb retail sales	0.1%	0.3%	0.4%	Should be a better month. Price discounting fierce.
Chn	Mar Caixin China PMI services	54.2	54.6	–	Delayed versus NBS measure; still a useful cross check.
Eur	Feb unemployment rate	8.6%	8.5%	8.5%	Set to continue trending lower.
	Mar CPI %yr advance	1.2%	1.4%	1.4%	Flash estimate; benign conditions to persist.
US	Mar ADP employment change	235k	200k	180k	Due a softer month.
	Mar Markit services PMI final	54.1	–	–	Services sector also in a strong position.
	Mar ISM non–manufacturing	59.5	59.0	–	Similarly points to sustained strength in conditions.
	Feb factory orders	–1.4%	1.7%	–	Preliminary durables reversed Jan's drop.
	Fedspeak	–	–	–	Bullard on US economy and policy.
	Fedspeak	–	–	–	Mester on diversity in economics.
Thu 5					
NZ	Mar QVNZ house prices, %yr	6.5%	–	–	Falls in mortgage rates boosted prices in recent months.
	Mar ANZ commodity prices	2.8%	–	–	May soften a little but remains at robust levels.
Aus	Feb trade balance, AUDbn	1.06	0.7	0.5	Surplus to narrow, exports dented by pull–back in gold.
	Mar AiG PSI	54.0	–	–	Services expansion led by business segments.
Eur	Mar Markit services PMI	55.0	55.0	–	Strength broad based across sector.
UK	Mar Markit services PMI (final)	54.5	54.2	–	Softness in household spending remains a drag.
US	Initial jobless claims	–	–	–	Remains at historically low level.
	Feb trade balance US$bn	–56.6	–55.8	–	Expected to be little changed in Feb.
	Fedspeak	–	–	–	Bostic on financial literacy.
Fri 6					
US	Mar non–farm payrolls	313k	189k	170k	Due a softer month; could come in revisions instead.
	Mar unemployment rate	4.1%	4.0%	4.0%	Participation has held off push below 4.0%.
	Feb consumer credit US$bn	13.91	15.0	–	Credit card usage jumped in late 2017.
Sat 7					
Chn	Mar foreign reserves $bn	3134.48	–	–	Edging higher; authorities in control.
Sun 8					
Chn	Mar foreign direct investment %yr	0.8%	–	–	To become a focus of trade discussions. Tentative date 8–18.
	Boao Forum for Asia	–	–	–	Annual meeting modelled on World Economic Forum. 8–11.

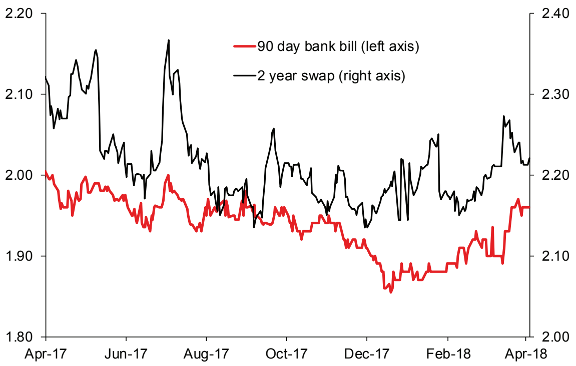
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2017	2018			Calendar years			
% change	Dec(a)	Mar	Jun	Sep	2016	2017	2018f	2019f
GDP (Production)	0.6	0.6	0.6	0.7	4.0	2.9	2.7	3.0
Employment	0.5	0.4	0.4	0.4	5.8	3.7	1.4	1.0
Unemployment Rate % s.a.	4.5	4.4	4.4	4.4	5.3	4.5	4.5	4.7
CPI	0.1	0.5	0.4	0.6	1.3	1.6	1.7	1.5
Current Account Balance % of GDP	-2.7	-2.2	-2.3	-2.5	-2.2	-2.7	-2.4	-2.7

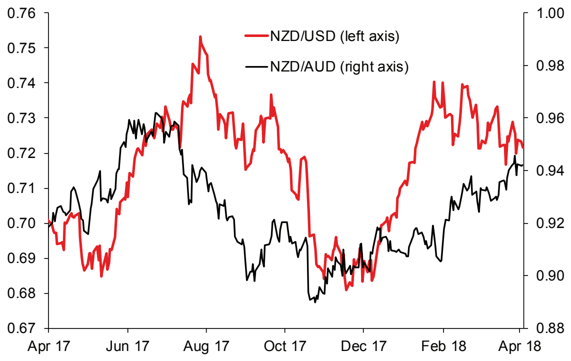
[1] Annual average % change

Financial Forecasts	Jun-18	Sep-18	Dec-18	Mar-18	Jun-19	Sep-19
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	1.90	1.90	1.90	1.90	1.90	2.05
2 Year Swap	2.10	2.20	2.30	2.40	2.55	2.70
5 Year Swap	2.70	2.80	2.95	3.10	3.20	3.30
10 Year Bond	3.00	3.10	3.30	3.40	3.45	3.50
NZD/USD	0.70	0.69	0.67	0.65	0.64	0.64
NZD/AUD	0.91	0.91	0.91	0.90	0.90	0.91
NZD/JPY	76.3	75.9	74.4	72.8	71.0	70.4
NZD/EUR	0.57	0.57	0.55	0.55	0.53	0.52
NZD/GBP	0.54	0.54	0.55	0.55	0.53	0.53
TWI	72.6	72.2	70.8	69.4	68.6	68.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 3 April 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.88%	1.81%	1.81%
60 Days	1.92%	1.87%	1.87%
90 Days	1.96%	1.93%	1.93%
2 Year Swap	2.22%	2.27%	2.27%
5 Year Swap	2.62%	2.73%	2.73%

NZ foreign currency mid-rates as at 3 April 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7216	0.7222	0.7244
NZD/EUR	0.5865	0.5879	0.5865
NZD/GBP	0.5137	0.5178	0.5246
NZD/JPY	76.44	76.53	76.39
NZD/AUD	0.9421	0.9362	0.9322
TWI	74.39	74.58	74.63

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017	2018f	2019f
Australia						
Real GDP % yr	2.6	2.5	2.6	2.3	2.7	2.5
CPI inflation % annual	1.7	1.7	1.5	1.9	2.1	1.9
Unemployment %	6.2	5.8	5.7	5.5	5.4	5.5
Current Account % GDP	-3.0	-4.7	-3.1	-2.3	-2.2	-3.4
United States						
Real GDP %yr	2.6	2.9	1.5	2.3	3.0	2.5
Consumer Prices %yr	1.6	0.1	1.3	2.1	2.3	2.1
Unemployment Rate %	6.2	5.3	4.9	4.4	4.0	3.7
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	0.3	1.1	1.0	1.5	1.3	1.0
Euroland						
Real GDP %yr	1.3	2.0	1.8	2.4	2.1	1.6
United Kingdom						
Real GDP %yr	3.1	2.2	1.8	1.7	1.6	1.6
China						
Real GDP %yr	7.3	6.9	6.7	6.9	6.3	6.1
East Asia ex China						
Real GDP %yr	4.2	3.8	3.9	4.5	4.3	4.3
World						
Real GDP %yr	3.6	3.4	3.2	3.8	3.9	3.7
Forecasts finalised 14 March 2018						

Interest Rate Forecasts	Latest	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	2.03	1.84	1.83	1.82	1.81	1.80	1.78	1.78
10 Year Bond	2.59	2.80	2.95	3.15	3.20	3.10	3.20	3.15
International								
Fed Funds	1.625	1.875	2.125	2.125	2.375	2.625	2.625	2.625
US 10 Year Bond	2.78	2.90	3.10	3.35	3.50	3.40	3.40	3.30
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.20	0.00	0.00	0.00

Exchange Rate Forecasts	Latest	Jun-18	Sep-18	Dec-18	Mar-18	Jun-19	Sep-19	Dec-19
AUD/USD	0.7663	0.77	0.76	0.74	0.72	0.71	0.70	0.70
USD/JPY	106.81	109	110	111	112	111	110	110
EUR/USD	1.2311	1.23	1.22	1.21	1.19	1.21	1.23	1.26
AUD/NZD	1.0628	1.10	1.10	1.10	1.11	1.11	1.09	1.08

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