FLASHNOTE

22 January 2016

HSBC Global Research

RBNZ Observer

On hold for now, but low inflation a concern

MACRO
NEW ZEALAND

ECONOMICS

- CPI inflation surprised to the downside in Q4 2015, falling to a 15-year low of 0.1% y-o-y as petrol prices plunged again
- At the same time, the 100bp of cuts delivered in 2015 (the most recent 25bp of which was in December) have lifted the timely domestic activity indicators
- We see the RBNZ on hold in January, given the pick-up in domestic demand, but expect that low inflation will drive a further 50bp of cuts in mid-2016 (in Q2 and Q3)

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More cuts are likely, just not yet

CPI inflation ended 2015 at just 0.1% y-o-y, the lowest rate in over 15 years and a material downside surprise to the RBNZ's forecasts. Continuing oil price declines threaten to tip New Zealand into outright deflation (in annual terms) in 2016. With inflation close to zero and well below target, the possibility of another rate cut has risen.

However, we do not expect a cut at the RBNZ's January meeting. First, the RBNZ itself seemed to adopt a fairly cautious attitude during the second half of 2015, with a lot of rhetoric about central banks needing to move gradually in a world of heightened uncertainty. After 100bp of cuts in 2015, the last of which arrived in December, we expect that the central bank will want to pause and judge the effects for some time.

Second, the New Zealand economy does not appear to be at risk of a near-term slowdown in growth, as happened during H1 2015 and prompted last year's rate cuts. Instead, the timely activity readings are at encouraging levels, domestic demand remains solid and the tourism sector (which is around 10% of the economy) is booming. House price inflation is also raising financial stability risks and the RBNZ may need more time to assess the impact of recent macro-prudential tightening.

Finally, the RBNZ is expected to 'look through' much of the weakness in Q4 CPI inflation as falls in petrol and food prices were a major drag in the headline numbers. Excluding food and energy, annual inflation was unchanged at 0.9%. Although this is still uncomfortably low, we think that the stability will reduce the urgency to cut further.

We do expect two more 25bp cuts in 2016, starting in Q2 (although a cut at the March meeting is an increasing possibility). Even ignoring the oil price impact, we believe inflation pressures will remain too low for the RBNZ to credibly project a return to 2% average inflation over the medium term, forcing it to act.

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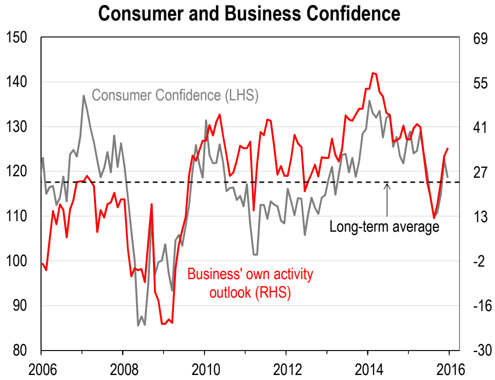
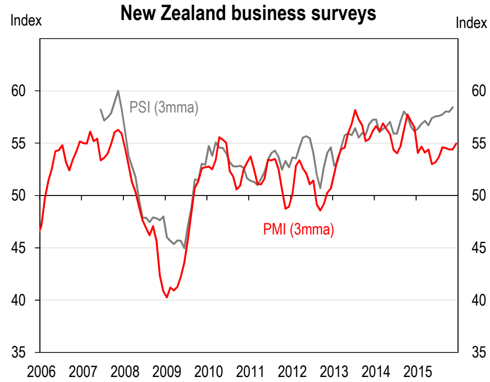
1. Confidence rebounded in H2 2015



Source: Bloomberg

2. Activity indicators have lifted



Source: Bloomberg

Timely activity indicators have strengthened

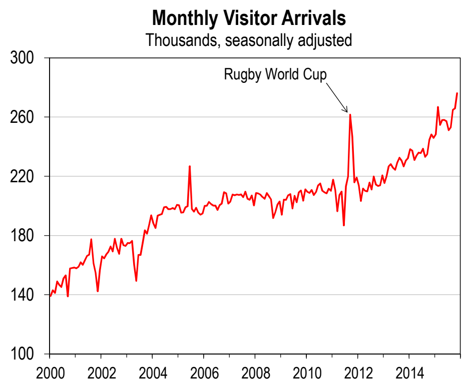
The New Zealand economy has been through a pronounced mini-cycle over the past couple of years. Growth was strong in 2014, at 3.7%, prompting 100bp of policy rate hikes. However, momentum then slowed abruptly in H1 2015, with confidence readings falling sharply and GDP growing at an annualised pace of just 1.0%. This saw the RBNZ unwind the previous hikes, cutting the policy rate by 100bp between June and December 2015.

Those cuts, possibly aided by a partial rebound in dairy prices, have supported a rebound in sentiment. Over the second half of 2015, consumer confidence and businesses' expectations for their own activity levels recovered to above-average levels (Chart 1). The PMI also lifted towards the end of the year and the PSI (a gauge of services sector activity) has been at the highest level since before the global financial crisis (Chart 2). This has been aided by record international visitor arrivals, driven by remarkable growth in tourist arrivals from China (Chart 3).

So, although the dairy sector is expected to be a drag on growth in 2016, as prices remain low and output is cut, growth looks to be holding up well. We expect growth of around 2.4% in both 2016 and 2017.

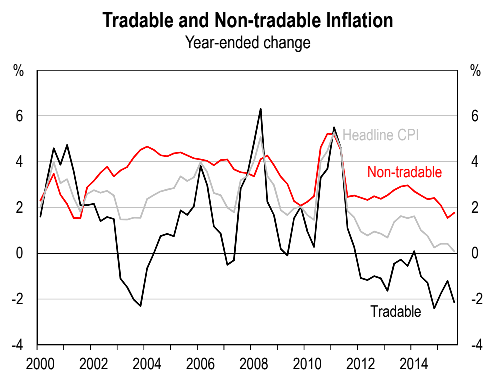
At the same time, the RBNZ remain concerns about rising housing prices. Auckland house prices have risen by 80% over the past four years. This is a growing risk to financial stability and means further rate cuts will be approached with caution. New macro-prudential rules were introduced in November, but it will take some time to assess their impact.

3. Tourism is booming



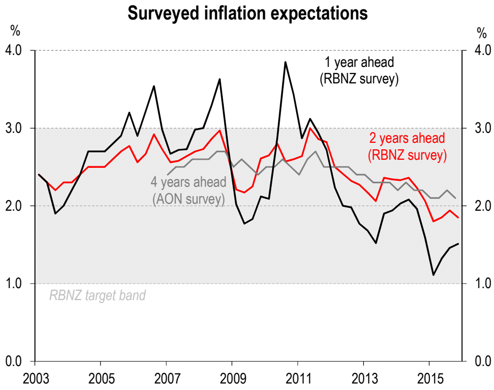
Source: Statistics New Zealand

4. CPI inflation fell to 0.1% y-o-y in Q4



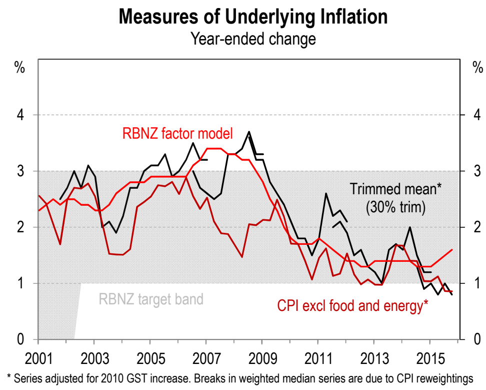
Source: Statistics New Zealand

5. Inflation expectations have edged lower



Source: RBNZ, AON

6. Underlying inflation is too low



Source: Statistics New Zealand, RBNZ

Inflation is too low, although headline CPI overstates the problem

While growth has been, on the whole, quite solid over the past couple of years, inflation has remained weak; CPI inflation has been below 2% for four years and counting (Chart 4). A significant driver of the low inflation readings seen over 2015 were the falls in global oil prices, which affect domestic petrol prices, as well as falling food prices.

Despite this, low headline inflation does bear risks, particularly if it results in lower inflation expectations. Continued falls in oil prices suggest headline inflation will stay low through most of 2016, increasing the risk of low inflation becoming embedded. So far, medium-term expectations have fallen but remain around 2% (Chart 5). Further falls could become a concern.

Despite the weakness in CPI, the RBNZ will be more focussed on various measures of core or underlying inflation, which are designed to gauge the pulse of inflation. A look at some underlying measures shows that the low inflation problem may not be as great as suggested by the CPI numbers (Chart 6). In particular, underlying inflation did not fall markedly in Q4. In fact, the RBNZ's own sectoral factor model of underlying inflation lifted to 1.6% y-o-y, the strongest since September 2011. On this evidence, the case for a January cut has not strengthened.

However, underlying inflation is still too low. The trimmed mean and CPI excluding food and energy are both below the bottom of the target band, at 0.8% and 0.9%, respectively. Non-tradable (domestically-generated) inflation, which the RBNZ has most influence over, is also probably much too low for overall inflation to rise to 2% on a sustained basis. In our view, the current pace of growth is unlikely to prove strong enough to create greater domestic inflation pressure and so we expect further cuts will be necessary around the middle of this year. For a more detailed discussion of inflation in New Zealand see *New Zealand Economics: A challenge for the 25-yr old inflation targeting regime*, 21 January 2016.

7. HSBC's main forecasts for New Zealand

	Year-average (%)			Year-ended (%)							
	2015	2016f	2017f	Q415f	Q116f	Q216f	Q316f	Q416f	Q117f	Q217f	Q317f
GDP	2.4	2.4	2.4	2.0	2.3	2.6	2.4	2.4	2.5	2.4	2.3
CPI	0.3	0.7	1.5	0.1	0.4	0.4	0.6	1.3	1.5	1.5	1.5
NZD/USD^	0.68	0.68	0.68	0.68	0.68	0.68	0.68	0.68	0.68	0.68	0.68
Cash rate^	2.50	2.00	2.00	2.50	2.50	2.25	2.00	2.00	2.00	2.00	2.00
Market pricing											
OIS implied^	n/a	2.24	n/a	n/a	2.38	2.29	2.24	2.24	2.26	n/a	n/a

Source: Statistics New Zealand, RBNZ, HSBC estimates. ^end-period

Disclosure appendix

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