10 March 2016

We Should Have Known Better!

- Mechanistic approach lowers inflation projections
- And forces RBNZ to cut cash rate to 2.25%
- It also demands more OCR cuts ahead
- Thanks to weakening external metrics and falling inflation expectations
- Common sense not a model variable

We should have known better. The RBNZ has taken the above-expected TWI, the lower than expected inflation expectations outcome, weaker global growth and a drop in commodity prices and poked all these things mechanistically into its model. The end result of that process is that inflation forecasts fell (which we knew with a large degree of certainty) and, accordingly, the model demanded a reduction in the overnight cash rate to compensate. The Reserve Bank has obliged by reducing the New Zealand cash rate to 2.25% and intimated that there is at least one more cut to come.

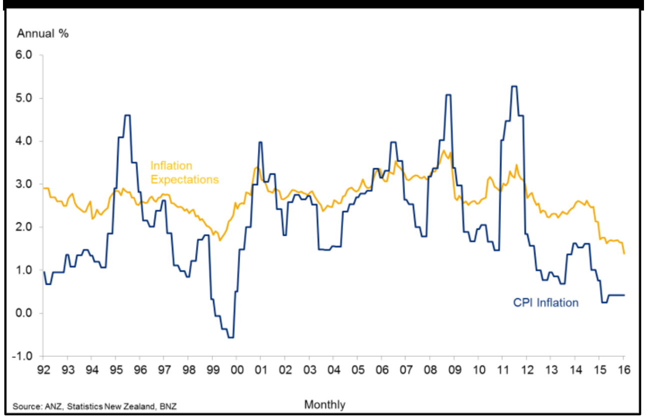
What's missing in this process is:

- Consistency with past RBNZ commentary;
- Any strong rationale that the rate cut will affect the desired objective of getting inflation to 2.0%;
- Any evidence that low inflation is causing a significant problem to the economy anyway.

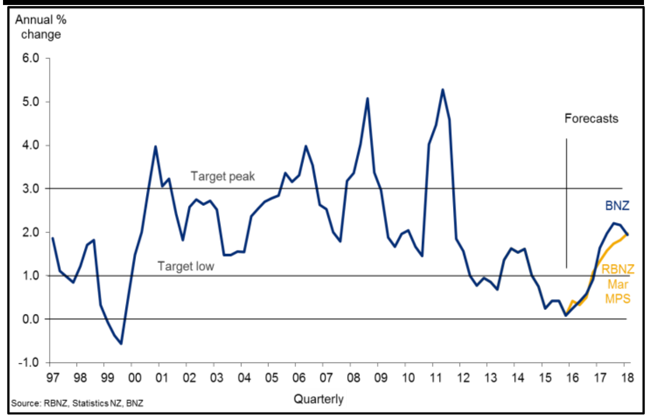
For us it's the consistency aspect (or lack of it) that is most galling. This is the second time in two years that we have listened to a speech by Graeme Wheeler and been stupid enough to pay attention to it. For example:

In Wheeler's February speech a lot was made of the Bank's factor model showing core inflation to be at 1.6%. A level which was seen as "encouraging" and "well within the target range". Now this core measure has been seemingly ditched and instead we are told we have

CPI Inflation and ANZ Inflation Expectations



Consumer Price Index



"subdued core inflation relative to history across a number of measures".

Wheeler also said that "the Bank would avoid taking a mechanistic approach to interpreting the PTA. Some commentators see a low headline inflation number and immediately advocate interest rate cuts". Looks like some central bankers now fall into the same category.

Concerns over "creating serious distortions in the financial system, housing market, and broader economy" seem to have dissipated.

As has the desire to look through movements in oil prices.

And then there's the internal consistency within today's statement. RBNZ officials were at pains to point out today that falling inflation expectations were a key to cutting rates. We had warned that the Reserve Bank might be pushing itself into a corner by pursuing this line of thought. And so it seems it has. With headline inflation continuing to print at very low levels it's almost certain that inflation expectations will continue to fall for the foreseeable future. Does that mean the cash rate will keep getting cut until inflation expectations stabilise? If so there could be many more reductions ahead. And despite using inflation expectations as the dominant reason for rate reduction the Monetary Policy Statement itself says "inflation expectations are still consistent with the Bank's inflation target".

And then there's the RBNZ's acknowledgement that "the weaker outlook for inflationary pressure in New Zealand predominantly reflects external developments". We couldn't agree more. And there's more to come. But the corollary to this is that there is nothing the RBNZ can do to impact these outcomes and domestic interest rate settings can only offer a partial offset while bringing wider costs to the economy to boot.

Where to now becomes a very interesting question? Is the "new" way of looking at things by the RBNZ here to stay or will its approach be upended again?

And last but not least, we reiterate that the question that needs to be addressed before all else is "is low inflation in this environment really that bad?" We don't think so.

What we do know is that the Bank's central forecasts have another rate cut in them and then the cash rate sticking at 2.0% for the foreseeable future. Logic would tell you that if the Bank's central view is a further reduction in rates that there is no need to wait for long meaning a further cut in the cash rate to 2.0% in April. But given that the RBNZ appears to be consistently inconsistent at the moment that would argue for something later, more or not at all.

We'll thus go for the middle ground in assuming a further reduction in rates at the June MPS with rates then staying on hold for an extended period of time. We have adjusted our forecast track accordingly. The balance of risk must be that rates fall even further given the RBNZ's current focus on external developments and inflation expectations.

If there was a strong rationale for today's cut it was that the RBNZ wanted to shock the currency market by delivering a rate reduction that was unexpected. In part it succeeded in doing this. The NZD TWI fell 2.0% on the day with the NZDUSD down roughly 1.5 cents to 0.6650 and the NZD/AUD off over a cent to 0.888. But even at these levels the NZD TWI still remains almost 1% above the "new" level built into the RBNZ's forecasts for the June quarter of this year. We do think the NZD will continue to drift lower but it's less to do with what will happen onshore than what we expect to happen offshore. And, of course, if this further reduction in interest rates does give the economy another boost then investors tend to demand the currencies of relatively well performing economies mitigating any impact that any interest rate differential change might impart.

And don't underestimate just how strong that economic performance could be. The RBNZ itself, despite stressing the miseries of the world, is still forecasting the New Zealand economy to grow 3.1% per annum over the two years ended March 2018. And, even more interestingly, this results in the unemployment rate falling to 4.9%. And, more generally, according to the RBNZ, "capacity pressures are projected to increase steadily… as annual GDP growth exceeds... potential".

So what have we learnt from today's Statement:

- The cash rate has been lowered to 2.25%
- Another cut is odds on
- Even then an easing bias will remain and
- Be very careful taking any speech that Governor Wheeler might give at face value.

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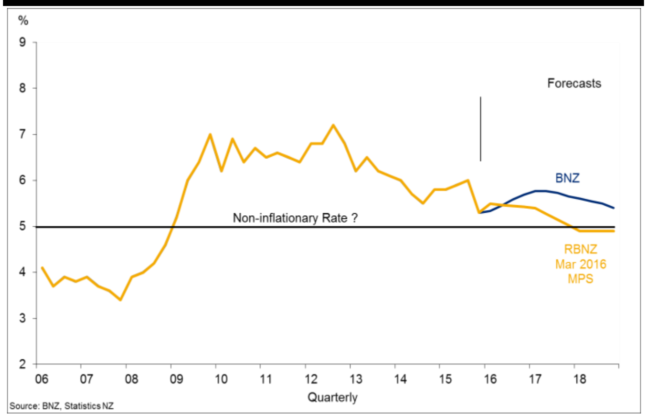
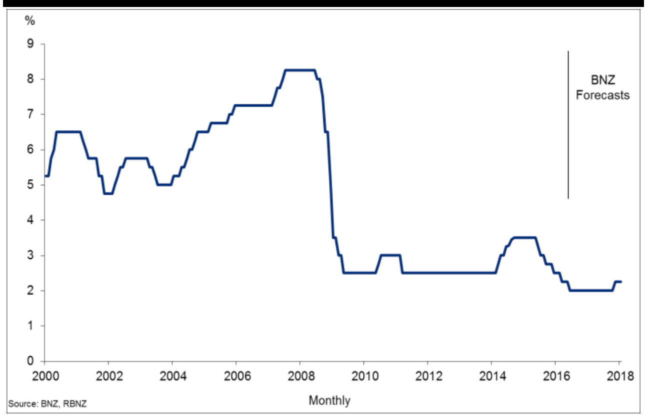
Unemployment Rate



NZ Cash Rate



The full text of today's RBNZ OCR Review – Official Cash Rate reduced to 2.25 percent

Statement by Reserve Bank Governor Graeme Wheeler:

The Reserve Bank today reduced the Official Cash Rate (OCR) by 25 basis points to 2.25 percent.

The outlook for global growth has deteriorated since the December Monetary Policy Statement, due to weaker growth in China and other emerging markets, and slower growth in Europe. This is despite extraordinary monetary accommodation, and further declines in interest rates in several countries. Financial market volatility has increased, reflected in higher credit spreads. Commodity prices remain low.

Domestically, the dairy sector faces difficult challenges, but domestic growth is expected to be supported by strong inward migration, tourism, a pipeline of construction activity and accommodative monetary policy.

The trade-weighted exchange rate is more than 4 percent higher than projected in December, and a decline would be appropriate given the weakness in export prices.

House price inflation in Auckland has moderated in recent months, but house prices remain at high levels and additional housing supply is needed. Housing market pressures have been building in some other regions.

There are many risks to the outlook. Internationally, these are to the downside and relate to the prospects for global growth, particularly around China, and the outlook for global financial markets. The main domestic risks relate to weakness in the dairy sector, the decline in inflation expectations, the possibility of continued high net immigration, and pressures in the housing market.

Headline inflation remains low, mostly due to continued falls in prices for fuel and other imports. Annual core inflation, which excludes the effects of transitory price movements, is higher, at 1.6 percent.

While long-run inflation expectations are well-anchored at 2 percent, there has been a material decline in a range of inflation expectations measures. This is a concern because it increases the risk that the decline in expectations becomes self-fulfilling and subdues future inflation outcomes.

Headline inflation is expected to move higher over 2016, but take longer to reach the target range. Monetary policy will continue to be accommodative. Further policy easing may be required to ensure that future average inflation settles near the middle of the target range. We will continue to watch closely the emerging flow of economic data.

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