

NEW ZEALAND ECONOMICS ECONOMIC COMMENT

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DEFLATING EXPECTATIONS

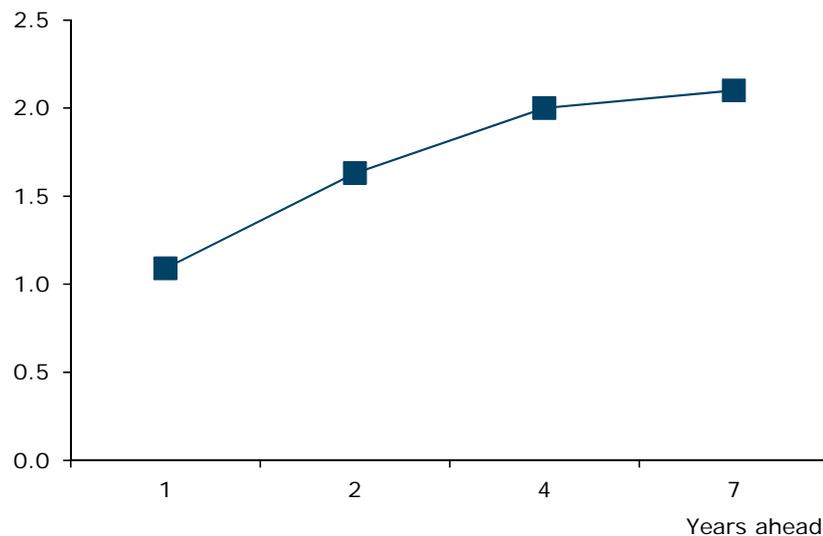
KEY POINTS

- **Falling inflation expectations have some musing on the OCR moving down, and sooner as opposed to later.** The reading from yesterday's RBNZ 2-year-ahead measure eased to 1.63% in Q1 from 1.85% in Q4, the lowest since 1994 and the fifth consecutive quarter below 2%. One-year-ahead CPI expectations fell to 1.09% from 1.51%, the lowest on record and the seventh consecutive quarter below 2%.
- **Inflation expectations are obviously a key part of any central bank's framework.** Officials don't want to see expectations "become unstable or decline significantly". We've seen scenarios from the RBNZ in the past where declining expectations necessitate an OCR response (March 2015 *Monetary Policy Statement*). Markets seem to be placing considerable weight on the RBNZ's 2-year measure despite the RBNZ trying to shift people's attention towards a wider array of measures.
- **While we are respectful of the general trend in some inflation expectation measures, we are coy about reading too much into recent shifts, particularly given the broader picture.**
 - Where actual expectations reside is actually unobservable; we can take guidance from surveys and market expectations but little more. Survey samples are generally small.
 - Statistically, near-term inflation expectations are linked to movements in petrol prices. They matter less for longer-term surveys.
 - Longer-term measures of inflation expectations have been considerably more stable. Two percent inflation appears on offer.
- **More broadly, central banks are whistling Dixie trying to hit their inflation targets in a world where:**
 - Legacy problems from the pre-GFC credit boom continue.
 - Debt levels in emerging markets have escalated post-GFC; that makes them the next crisis focal point.
 - Overcapacity in sectors like manufacturing exists.
 - Sharp swings in commodity prices have been evident. Dubai oil prices have more than halved in USD terms since last May. There are both cyclical and structural reasons for it.
 - We have the deflationary impact of disruptive technologies. It's huge.
 - Wage bargaining power has shifted, partly in response to technology putting more and more jobs at risk of being eliminated.
 - Consumer bargaining power has also shifted with the advent of online shopping and online price checking websites.
 - Currencies are becoming the mechanism through which local problems are exported; the US did it via a weaker USD and China is set to do it via the RMB.

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- **So there is no doubt the RBNZ is going to have continued problems hitting its inflation target as will all central banks.** Inflation expectations will be prone to drifting in such an environment. Inflation-linked bond break-evens around the globe are miles away from central bank targets, despite some central banks (Fed & RBNZ) still articulating anchored inflation expectation stories. But in a world of liquidity driven excesses, we don't think too many instruments are being priced based on pure fundamentals anyway.
- **Cutting the OCR in the face of greater leveraging behaviour (credit growth in excess of GDP – we have that), solid consumption growth (booming in H2 2015), and double digit house price growth is the recipe for an accident.** We are seeing structural metrics such as household saving deteriorate and debt to income ratios rise, at a time valuations are stretched. That's a potential Groundhog Day scenario of repeating nightmares. There are numerous central banks around the globe heading down this horror path, forsaking the long game for the short one. The RBNZ is thankfully not one of them (or is at least showing resistance to).
- **Forget about a rigid fixation with fighting inflation.** Locally, that's never been the case anyway (except in the Brash era). But the central bank reaction function now needs to be far more medium-term focused given the current state of affairs and complexities monetary policy currently faces.
- **Thankfully we to have a central bank in the same mind-set.** It was only two weeks ago the Governor played down a mechanistic approach to fighting inflation, preferring flexibility. That is entirely appropriate.
- **We don't expect too much concern within the RBNZ over the recent dip in 1 and 2 year inflation expectations.**

FIGURE 1. EXPECTED CPI SURVEY MEASURES
Q1 2016 Observations to date



Source: ANZ, RBNZ, Aon NZ

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