NEW ZEALAND ECONOMICS
RBNZ JANUARY OCR REVIEW

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MORE WRIGGLE ROOM

- **The RBNZ left policy unchanged today, as expected.** However, its concern over the global outlook and ability of inflation to return to its target range within a comfortable timeframe has increased.
- **Whereas the easing bias in December was conditional, a more explicit bias was evident today**, with the Bank noting that "some further policy easing may be required over the coming year to ensure that future average inflation settles near the middle of the target range."
- Despite maintaining an expectation of an improved growth backdrop over the year ahead – and even explicitly acknowledging core inflation at 1.6% and stable inflation expectations – low headline inflation remains a headache for the Bank. While it almost goes without saying given oil price moves, the RBNZ noted that "headline inflation is expected to increase over 2016, but take longer to reach the target range than previously expected." That creates presentational issues.
- **It was far from one-way traffic within the statement though.**
  - Growth is still very solid.
  - The RBNZ made explicit reference to core inflation being 1.6%. No doubt this acknowledgement is partly to dilute sensitivities towards a low headline inflation rate but it's still notable.
  - Housing risks are noted.
  - Both upside (immigration, pressure in the housing market) and downside (global growth and financial conditions, dairy) risks are specifically mentioned.
  - The NZD is adjusting; not as fast or as far as one would like, perhaps, but there is still movement.
- **This doesn't sound like a central bank ready to cut rates any time soon. But the door is open, and markets will run with this theme.**
- **We are still watching our 6 C's** (China, currency, commodity prices, cost of funds, credit growth and confidence). Some of those we can tick as being problematic and justifying a lower OCR now (cost of fund increases, low export prices) but **we are not seeing enough across the board, particularly with the domestic economy still performing well, to justify a material further easing in policy.**
- **While the easing bias has been "stepped up", the Bank stopped short of setting the scene for a March cut**, so it is difficult to argue with markets that are pricing the odds of a March cut around 50/50. We continue to favour receiving the short end on any back-ups. We also see the RBNZ's tone as reinforcing the overall downward trajectory for the NZD on a trade-weighted basis.

RBNZ OCR REVIEW

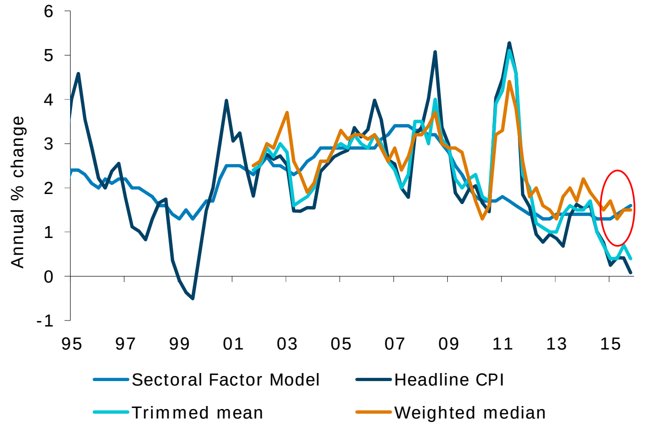
COMMENT

While today's decision to the leave the OCR unchanged at 2.5% was unsurprising, the tone of the statement was more dovish than we expected. Sure, we expected global risks and low headline inflation to be acknowledged (and hence the tone would be a little more dovish than expressed in December), but it is clear today that the RBNZ's concern over the global outlook and ability of inflation to return to its target range within a comfortable timeframe has increased more than we envisaged.

It is this apparent concern over the inflation outlook especially that has seen the RBNZ shift back to a more explicit easing bias. Whereas in December the easing bias was conditional and the RBNZ felt that current interest rate settings were appropriate to help drive a lift in inflation over the medium term, it now acknowledges that "some further policy easing may be required over the coming year to ensure that future average inflation settles near the middle of the target range."

If nothing else, low headline inflation is presenting the RBNZ with a presentational headache. At just 0.1% y/y, headline inflation has been below the bottom of its target band for five quarters now (and below 2% since 2011), and our expectation is that it could remain that way for most (if not all) of 2016. Despite maintaining an expectation of an improved domestic growth backdrop over the year ahead, with ongoing support from the likes of tourism, construction, net immigration and improved consumer and business sentiment – and even explicitly acknowledging core inflation at 1.6% and stable inflation expectations – low headline inflation remains a sticking point for the Bank. While it almost goes without saying given oil price moves, the RBNZ noted that "headline inflation is expected to increase over 2016, but take longer to reach the target range than previously expected."

FIGURE 1. HEADLINE CPI AND CORE INFLATION

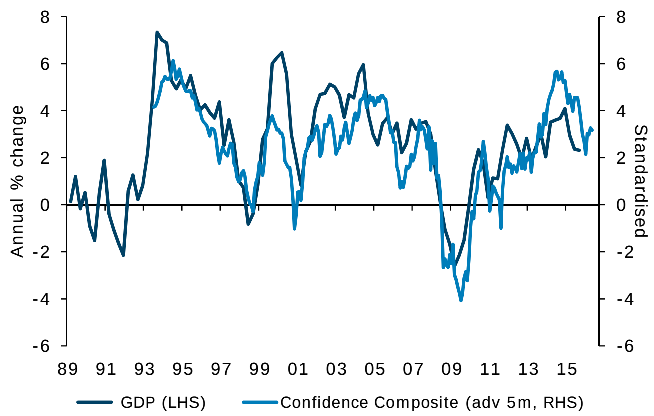


Source: ANZ, Statistics NZ, RBNZ

This obviously gave today's commentary a dovish tone. But it was far from one-way traffic. Specifically:

- Growth is still very solid and expected to increase over 2016. In December, the RBNZ projected a reasonable profile for domestic GDP growth (averaging 0.8% per quarter over 2016/17) and we doubt it will be changing that too much at its next update.
- The RBNZ explicitly referenced core inflation being at 1.6%. No doubt this acknowledgement is partly to dilute sensitivities towards a low headline inflation rate, but it's still notable.
- Housing risks are mentioned. Auckland is still seen as a "financial stability risk" and the RBNZ is aware that pressures are spreading, noting that "house price pressures have been building in some other regions."
- Both upside (immigration, pressure in the housing market) and downside (global growth and financial conditions, dairy) risks are specifically noted.
- The NZD is adjusting; not as fast or as far as one would like, perhaps, but there is still movement.

FIGURE 2. GDP VS CONFIDENCE COMPOSITE



Source: ANZ, Statistics NZ

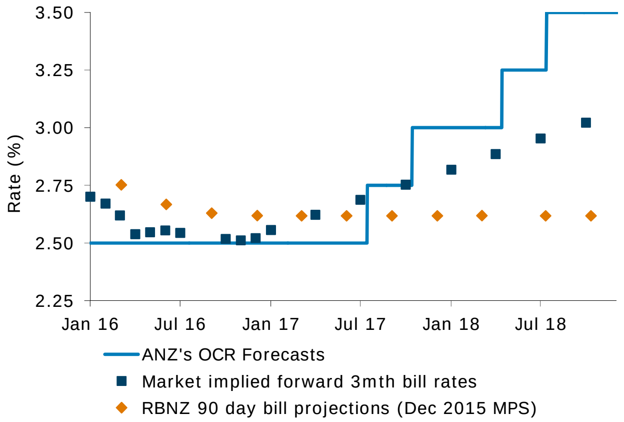
So to us, this doesn't really sound like a central bank ready to cut rates any time soon. It will of course respond if it needs to, but we judge the RBNZ to be a reluctant cutter at present.

Nonetheless, the door to easing has obviously been opened further, so markets will run with this theme. The NZD has eased on the day and the curve is a little lower. With the beauty of hindsight, perhaps this is the very market reaction the RBNZ wanted to generate following the negative moves (i.e. tightening in financial conditions) post December.

RBNZ OCR REVIEW

Our base-line forecast continues to be an extended period of OCR stability. But the risks are skewed towards easing so we are watching our 6 C's (China, currency, commodity prices, cost of funds, credit growth and confidence) closely. As we sit here today, some of those factors can already be ticked as being problematic and justifying a lower OCR now (cost of fund increases, low export prices). But we are not seeing enough across the board, particularly with the domestic economy continuing to perform well, to justify a material further easing in policy. But if more of these factors were to deteriorate and some of our leading indicators for the domestic economy begin to turn, then it could be game on for additional easing.

FIGURE 3. ANZ OCR FORECAST, MARKET IMPLIED FORWARD 90 DAY RATES AND RBNZ FORECAST



Source: ANZ, RBNZ, Bloomberg

STRATEGY

The tone of today's statement validates the recent shift in market expectations for policy. The easing bias has been "stepped up", but the Bank stopped short of setting the scene for a March cut, so it is difficult to argue with markets pricing odds of a March cut around 50/50. We continue to favour receiving the short end on any back-ups. We also see this RBNZ's tone as reinforcing the downward overall trajectory for the NZD on a trade weighted basis. Should economic conditions "require" further easing in 2016 it would also "require" a lower NZD. Short-term direction for NZD/USD is still dependent on the evolution of global risk sentiment, but we would expect this to weigh on NZD/AUD.

RBNZ OCR RELEASE

The Reserve Bank today left the Official Cash Rate unchanged at 2.5 percent.

Uncertainty about the strength of the global economy has increased due to weaker growth in the developing world and concerns about China and other emerging markets. Prices for a range of commodities, particularly oil, remain weak. Financial market volatility has increased, and global inflation remains low.

The domestic economy softened during the first half of 2015 driven by the lower terms of trade. However, growth is expected to increase in 2016 as a result of continued strong net immigration, tourism, a solid pipeline of construction activity, and the lift in business and consumer confidence.

In recent weeks there has been some easing in financial conditions, as the New Zealand dollar exchange rate and market interest rates have declined. A further depreciation in the exchange rate is appropriate given the ongoing weakness in export prices.

House price inflation in Auckland remains a financial stability risk. There are signs that the rate of increase may be moderating, but it is too early to tell. House price pressures have been building in some other regions.

There are many risks around the outlook. These relate to the prospects for global growth, particularly around China, global financial market conditions, dairy prices, net immigration, and pressures in the housing market.

Headline CPI inflation remains low, mainly due to falling fuel prices. However, annual core inflation, which excludes temporary price movements, is consistent with the target range at 1.6 percent. Inflation expectations remain stable.

Headline inflation is expected to increase over 2016, but take longer to reach the target range than previously expected. Monetary policy will continue to be accommodative. Some further policy easing may be required over the coming year 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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