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NEW ZEALAND ECONOMICS
RBNZ MARCH *MPS* REVIEW

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ACTION MAN

KEY POINTS

- **The RBNZ's decision to cut the OCR today to 2.25% was a clear surprise.** That's said, it's hard to argue with the spirit given that we expected rate cuts over the year (just not today).
- **Two factors were key in the decision**: a more fragile-looking global scene (though reasonable growth is still expected) and the recent decline in inflation expectations. Stress in the dairy sector, higher funding costs and the elevated NZD appear to have played secondary roles. And of course it's not one-way traffic, with the upside risks from migration and the possible return of the borrow-and-spend behaviour of old also acknowledged.
- **It is the downshift in inflation expectations of late that appears to have spooked the RBNZ somewhat.** Despite acknowledging that long-term measures have remained stable around 2%, it noted that "there has been a material decline in a range of measures" and this is "concerning". That's having a bob each way.
- **Importantly, the RBNZ also now looks to be acknowledging a shift in the inflation process.** Specifically, it notes the impending release of work showing how past inflation outcomes are having more of a bearing on pricing behaviour post the GFC (hence why the falls in inflation expectations are a concern). We await this work with interest.
- **Further easing has been signalled.** The forecasts showed the 90-day rate easing to 2.1% by the start of 2017, which hints at one further cut in the Bank's central scenario around mid-year.
- **We expect two more OCR cuts before year end.** Recent pressure on funding costs is not really a core part of the RBNZ's central track (of one cut today and another to come), but it was discussed in a scenario that involved an OCR well below 2%. We consider recent lifts funding pressures have a structural element. We also expect more downside risks around the globe to materialise as the year progresses, with the NZD to remain frustratingly elevated. That adds up to more than one cut before year end. The timing of this easing looks to be around mid-year for the first and late in the year for the second, although the Q1 CPI and how mortgage rates respond to today's action will be steering influences.
- **Short-end interest rates have fallen sharply, and are now pricing in a more dovish profile than is implied by the RBNZ's projections**. We see this as entirely appropriate and expect the 1yr-2yr curve to invert further, and for 1yr/1yr to gravitate towards 2% in coming weeks.
- **The NZD dropped sharply on the news, and is likely to remain under pressure** as the market adjusts to the shift in RBNZ tone and signal of further easing. **However, it's hard to get overly bearish on the NZD** given respectable growth locally, solid yield still on offer in a yield-hungry world and prospects for even more stimulatory policy (a push into more negative rates) in other parts of the globe.

RBNZ *MPS* REVIEW

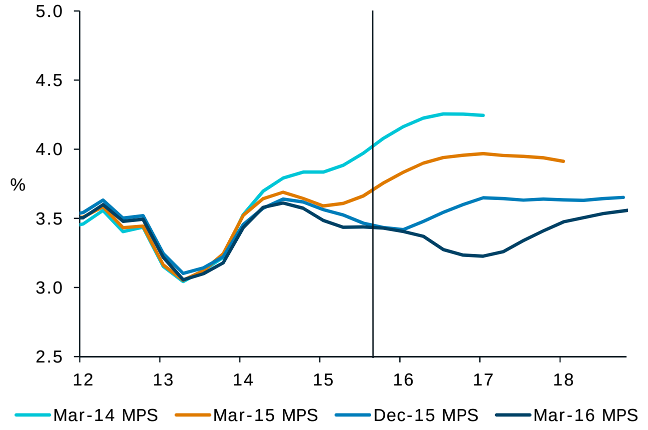
KEY POINTS

The RBNZ cut the OCR by 25bps to an all-time low of 2.25% today. While we were expecting an easing at some stage this year (and therefore can't argue with the overall spirit of today's decision), the timing was a surprise. We felt that the RBNZ would maintain the cash rate at 2.5% but open the door further to the potential of future easing, awaiting additional information. However, clearly the RBNZ felt that the risk profile had shifted enough to warrant action today.

Two factors played a key part in today's decision to cut:

1. **A more fragile-looking global scene.** The RBNZ has lowered its forecasts for trading partner growth (albeit only modestly), but continues to see the risks skewed lower. In particular, it noted that "the risk of a sharp slowdown in Chinese growth remains elevated" and it also expects global "commodity prices to be subdued for a sustained period." We concur with both.

FIGURE 1. RBNZ TRADING PARTNER GROWTH FORECASTS



Source: ANZ, RBNZ

2. **The recent decline in inflation expectations. In fact, this looks to have spooked the RBNZ somewhat.** Although it acknowledged that long-term measures have remained stable around 2%, it noted that "there has been a material decline in a range of measures" and that this "is a concern because it increases the risk that the decline in expectations becomes self-fulfilling."

Importantly, the RBNZ now looks to be acknowledging a shift in the inflation process. Specifically, it notes the impending release of work showing how past inflation outcomes are having more of a bearing in pricing behaviour post the GFC (and hence why the recent falls in inflation expectations are of concern). The RBNZ has "built the results of that analysis into our forecasts, and formally into our forecasting models." **So we await this work with great interest.**

Our Monthly Inflation Gauge has been picking tension between structural forces (keeping inflation lower) and traditional demand-pull factors. This Gauge will remain key for us as we weigh up which force is dominating. **At present there is enough in the former to offset the latter, leaving aggregate pressure benign.**

The RBNZ still believes that inflation pressures will lift from here (albeit more slowly than previously signalled). That reflects an expectation that domestic growth prospects remain solid, with GDP growth of around 3% for the next two years, supported by net migration, construction, tourism and monetary policy support (past action as well as today's cut and one more). This "will put increasing pressure on productive resources, and so price and wages." It's just that "the weaker outlook for inflation pressures in New Zealand predominantly reflects external developments."

Additional developments look to have played more of a secondary role in today's decision. As mentioned, most of the concern was centred on the global growth backdrop and weaker inflation expectations. However, the RBNZ also acknowledged the elevated NZD (with it above its previous assumptions) and that a decline would be "appropriate"; ongoing pressures in the dairy sector; and the recent increases in bank funding costs. On the latter, it was noted that while strong domestic deposit growth provided some insulation, "acceleration in credit growth over the past year might increase banks' reliance on higher-cost long-term wholesale funding, leading to higher New Zealand mortgage rates."

Further easing is signalled from here. The RBNZ's 90-day bank bill projection eases to 2.1% by the start of 2017. Mechanically, that is a signal of one further OCR cut this year, and the timing of this looks to be around mid-year. Qualitatively, the RBNZ maintained similar forward guidance as that laid out in January: "further policy easing may be required to ensure that future average inflation settles near the middle of the target range."

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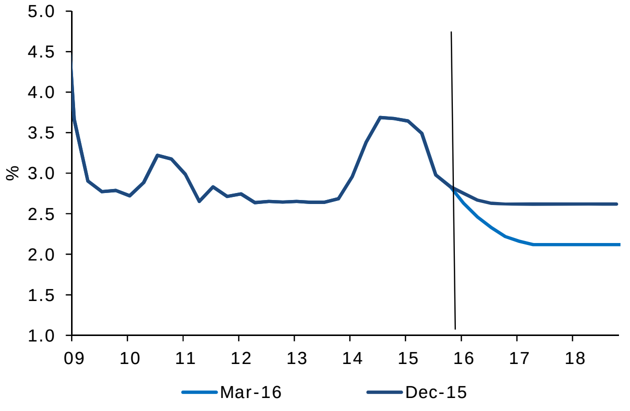
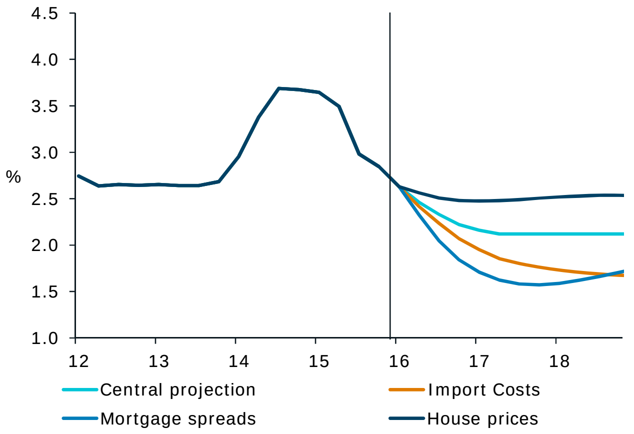
FIGURE 2. RBNZ 90-DAY INTEREST RATE PROFILE



Source: ANZ, RBNZ

But the risk profile around this outlook has a downward skew. To be fair, the RBNZ is not dismissing upside risks to the outlook entirely; it showed a scenario wherein stronger house price inflation and consumption growth resulted in a less stimulatory outlook for policy. However, the language in the Statement and alternative downside scenarios presented hinted strongly as to where it saw the main direction of risks. These alternative scenarios showed first, a further decline in inflation expectations affecting wage and price setting behaviour, and second, a weaker outlook for global growth, causing either lower commodity prices or higher funding costs. We concur with the spirit of these risks, although we perhaps have a little more immediate concern over the structural elements to funding pressures at present.

FIGURE 3. SCENARIO 90-DAY INTEREST RATE PATHS



Source: ANZ, RBNZ

OUR VIEW

We now expect two more OCR cuts before year end, taking the OCR to 1.75%. Recent pressure on funding costs is not really a core part of the RBNZ's central track (of one cut today and another to come), but it was discussed as a scenario that involved an OCR well below 2%. Given recent funding pressures look to have somewhat of a structural element to them, and our view that more downside risks around the globe will materialise as the year progresses, we expect more than one additional cut before year end.

We pencil in the timing of these cuts to be around mid-year for the first and late in the year for the second. That said, the Q1 CPI will be important. If it shows that core inflation has softened, then a further cut as soon as April becomes a real possibility.

We will be closely eyeing mortgage rates to see the degree of pass-through into retail borrowing rates. Less pass-through ups the ante on a lower OCR to offset. That's the signal coming from funding costs.

But stepping back, despite our expectations that a lower OCR will be required, we have some lingering concerns about the steps central banks are taking to get inflation up in a world where structural forces make that job extremely difficult. Each marginal tweak lower in the OCR needs to be carefully considered. Locally, the housing market outside of Auckland has gone ballistic. Auckland house price growth may have moderated, but the level of prices remains stratospheric – as does net migration. Moreover, households are leveraging up again. A lower OCR is therefore not a free lunch.

Globally, it seem like central banks are in a race to the bottom (and below the zero mark in some instances) and that leaves us mindful. Currency wars are rife; there is plenty of asset price inflation but no general consumer price inflation; we worry about the unintended consequences of these actions (such as negative yields leading wider credit spreads and lower liquidity). Ultimately, we feel there is too much reliance on central banks in the first instance to stimulate growth and too little chatter (pressure) on fiscal policymakers to drive better microeconomic outcomes.

In this world, New Zealand is the unfortunate two-bit player at the international roulette table.

FINANCIAL MARKET IMPLICATIONS

Short-end interest rates have fallen sharply, and are now pricing in a more dovish profile than that implied by the RBNZ's projections (we see fair value for the 2-year swap at around 2.34% based on the RBNZ's bill projections, and the market is currently trading at around 2.26%). We see this as entirely appropriate given our expectation that the

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OCR will go below 2% by the end of the year (ie more cuts than the RBNZ is flagging). We expect the 1yr-2yr curve to invert further, and for 1yr/1yr to gravitate towards 2% in coming weeks.

The NZD dropped sharply on the news, and is likely to remain under pressure as the market adjusts to the significant downward revision to the Bank's 90-day bill projections, and its acknowledgement that there are scenarios (lower import costs and wider mortgage spreads) that could see the OCR go below 2%. **However, it's hard to get overly bearish the NZD** given respectable growth locally, solid yield still on offer in a yield-hungry world, and prospects for even more stimulatory policy (a push into more negative rates) in other parts of the globe.

RBNZ MARCH *MPS* PROJECTIONS (DECEMBER 2015 *MPS* IN BRACKETS)

	90-Day	TWI (Qtr Average)	CPI (Ann % Chg)	GDP (Ann % Chg)
Q1 2015	3.6 (3.6)	77.9 (77.9)	0.3 (0.3)	3.0 (3.0)
Q2	3.5 (3.5)	76.1 (76.1)	0.4 (0.4)	2.4 (2.4)
Q3	3.0 (3.0)	69.8 (69.8)	0.4 (0.4)	2.3 (2.1)
Q4	2.8 (2.8)	72.1 (70.7)	0.1 (0.4)	2.1 (1.7)
Q1 2016	2.6 (2.8)	72.3 (69.4)	0.4 (1.2)	2.6 (2.3)
Q2	2.5 (2.7)	70.9 (68.4)	0.3 (1.2)	3.1 (2.7)
Q3	2.3 (2.6)	70.4 (67.9)	0.5 (1.2)	3.0 (2.8)
Q4	2.2 (2.6)	70.0 (67.7)	1.1 (1.6)	3.0 (3.1)
Q1 2017	2.2 (2.6)	69.8 (67.6)	1.3 (1.5)	3.0 (3.1)
Q2	2.1 (2.6)	69.5 (67.5)	1.6 (1.6)	2.9 (3.3)
Q3	2.1 (2.6)	69.3 (67.3)	1.7 (1.7)	3.0 (3.5)
Q4	2.1 (2.6)	69.2 (67.1)	1.8 (2.0)	3.2 (3.6)
Q1 2018	2.1 (2.6)	69.2 (67.2)	2.0 (2.0)	3.1 (3.4)
Q2	2.1 (2.6)	69.2 (67.3)	2.0 (2.0)	3.1 (3.1)
Q3	2.1 (2.6)	69.2 (67.3)	2.0 (2.2)	2.8 (2.8)
Q4	2.1 (2.6)	69.2 (67.4)	2.1 (2.1)	2.4 (2.4)
Q1 2019	2.1	69.3	2.0	2.2

MARCH *MONETARY POLICY STATEMENT* POLICY ASSESSMENT

Official Cash Rate reduced to 2.25 percent

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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