Harbour Navigator

RBNZ: Inflation. What inflation?

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At yesterday's Monetary Policy Statement (MPS) release the Reserve Bank of New Zealand (RBNZ) genuinely surprised financial markets, by assessing that the economic data received since February had a neutral impact on the appropriate stance of monetary policy. While in the lead up many commentators had focused on the recent jump in annual Consumer Price Index (CPI) inflation, the RBNZ's response could be summed up as "what inflation?"

Market analysts had expected to see a higher projected Official Cash Rate (OCR) and an earlier commencement to rate hikes than previously projected. However, the RBNZ maintained the line that "*monetary policy will remain accommodative for a considerable time*[1]" and OCR hikes are not projected until H2 2019. About the only thing markets predicted correctly was that the OCR remained at 1.75% on the day.

Market analysts and economists, many of whom have honed their skills working at the RBNZ, are well-practiced in assessing incoming data and making judgements about the implications for monetary policy. This also occurs in a pretty transparent communication loop with the Reserve Bank. Consequently, we see it as fairly unusual for the market to be genuinely surprised. So where were the differences?

The market had considered that the combination of surprisingly higher headline CPI inflation, the 4% fall in the New Zealand Dollar Trade-Weighted Index, rising 2-year inflation expectations and ongoing strong migration more than offset the impact of moderating house prices and higher funding costs on the medium-term inflation outlook. Many models run by market economists that are designed to mimic RBNZ internal models certainly supported this expectation.

In contrast, the RBNZ's view is that the recent rise in the CPI is temporary and will largely reverse, as it has been partly driven by food and oil prices. Their preferred measures of long-term inflation and current core inflation remain stable and they see global risks persisting. At the press conference immediately after the MPS release, the Governor of the RBNZ and officials also stressed the absence of wage pressures and subdued global inflation.

We believe there are two main factors driving the RBNZ's reluctance to claim victory on getting CPI inflation back to the mid-point of the target range.

First, after experiencing CPI inflation surprise on the downside consistently for five years between 2011 and 2016, the RBNZ is likely hesitant to read too much into the fact that the last two quarters of CPI inflation have been above expectations. Having witnessed the strength of global deflationary forces in recent years, and having faced criticism for tightening too early in 2014, we believe the RBNZ now requires a very high threshold of evidence to change their view and adjust their communications.

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[1] Taken from the RBNZ Monetary Policy Statement, 11/05/2017

The second reason may come down to tactics. No one is arguing for an immediate OCR hike. However if the RBNZ had indeed signalled an earlier start to hikes, the market would quite likely have been encouraged by the shift and taken the New Zealand dollar and medium-term interest rates higher, thereby delivering an effective tightening in conditions, which the RBNZ doesn't want to see yet.

Maintaining their prior dovish stance, especially as it surprised markets, may help the RBNZ in two ways. It helps reinforce the prospect that inflation returns sustainably to the middle of their target range. It also allows the RBNZ to argue they are being consistent with strategy and messaging, even if the market feels the data justifies a change.

For markets, the immediate reaction was a sharp fall in the NZ dollar and 2-year swap rates. These moves should hold for now, but may reverse over time if inflation does persist above 2%. For us, the RBNZ's 'dovish' stance reinforces our preference for inflation-indexed bonds, as ongoing accommodative policy raises the likelihood that inflation exceeds the modest 1.25% p.a. inflation priced into these securities over the next 10 years.

Harbour Asset Management

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