7 February 2019

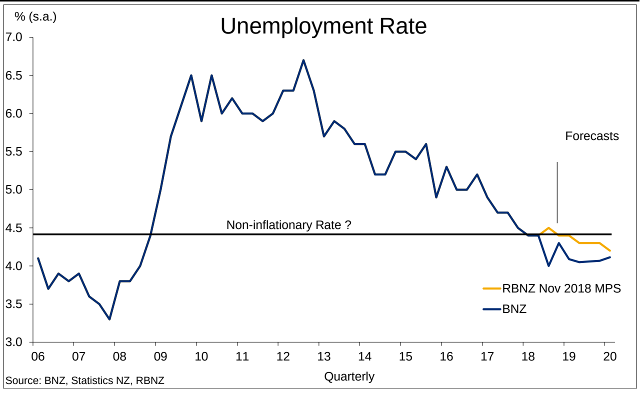
RBNZ Fully Employed

- **RBNZ has more pressing issues than monetary policy**
- **Helpful, then, that there's no urgency to shift rates, as targets largely met**
- **February MPS should be a November repeat**
- **Markets read today's labour data as dovish**
- **But bigger picture reveals potentially unsustainable strength**

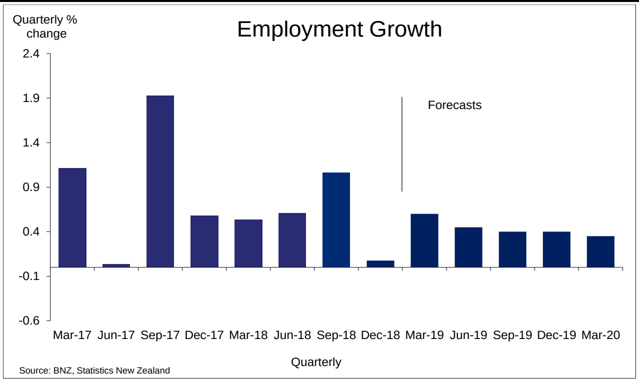
Financial markets clearly want to price in a cut in New Zealand's cash rate. Today's labour market data unequivocally came in weaker than market expectations but participants seem to have completely overlooked the fact that the overall picture remains relatively indifferent to what the RBNZ had assumed when it put together its November 2018 Monetary Policy Statement (MPS). Moreover, a host of partial indicators continue to tell us that the New Zealand labour market remains very tight and, certainly, very close to what might be conceived as maximum sustainable employment. Accordingly, we maintain our view that the RBNZ's February MPS will be a near repetition of its November missive.

Yes, the unemployment rate climbed to 4.3% in the December quarter but this was fairly unremarkable in the bigger picture. To start with, there were big question marks over the precipitous drop in the rate, to 3.9%, in the previous quarter. All were expecting a corrective bounce of some description. It was just a question of magnitude. As it turned out, not only did the bounce happen but the 3.9% was revised higher to 4.0%. Moreover, don't forget, that the RBNZ had assumed an unemployment rate of 4.4% for Q4 so should not have been spooked by the outturn.

Labour Market Tight



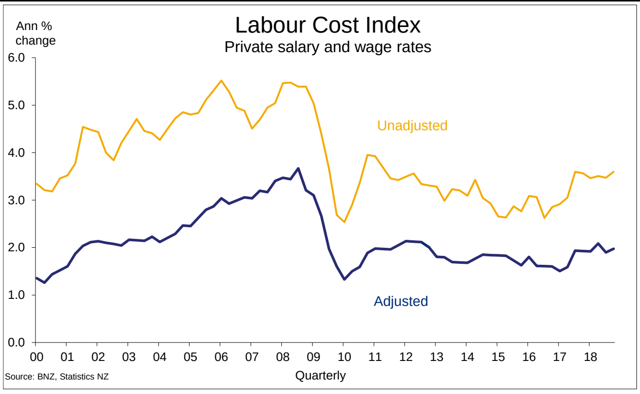
Solid Employment Growth



On the employment front, the RBNZ had a 2.1% pick for the annual increase, the actual outcome was 2.3%. Sure, the quarterly increase was a relatively miserable 0.1% but this reflects the over-sized 1.1% jump in the previous quarter. Average the two and you have employment growing at 0.6% per quarter. In fact 0.6% is the average for the last five quarters and the pace of growth that we expect to be resumed through the first quarter of this year.

Perhaps the genuinely remarkable piece of data released today appeared, again, in the earnings figures. The private sector labour cost index rose just 0.5% to be up 2.0% on year earlier levels. This was a smidgen (0.1%) lower than we, the RBNZ and the market had anticipated. We keep waiting for wage pressure to reveal itself but it looks like that wait will be further extended. That aside, the annual increase remains consistent with the mid-point RBNZ's inflation target range and we, again, highlight the fact that

Wage Growth Constrained



the unadjusted labour cost index rose a much higher 3.6% for the year. This feels closer to the truth in terms of overall wage pressure and it is a rate of increase that has not been exceeded since June 2011.

The labour market data certainly had the potential to throw the cat amongst the pigeons down at the Reserve Bank. It definitely did last time around but, in the event, there really wasn't anything in today's figures to get particularly excited about.

Surely, the RBNZ must now sit on its hands when it releases its February MPS next Wednesday. We see little justification for a shift to either a more, or less, aggressive stance than it held in November and we see significant justification for the Bank to buy itself more time.

In short

- The RBNZ Governor currently has more pressing issues to contend with than fiddling with interest rates;
- Significant staff and operational changes at the Bank suggest that now might not be the best time to move to a clear bias;
- On balance, the data are little changed from that presented at the time of the November MPS;
- Most importantly, for all intents and purposes, the Bank is achieving its targets;
- Current market pricing is unconcerning.

At a big picture level it seems to us that the Governor would like to be in a position where he doesn't need to worry about monetary policy for a while as he has more than enough to keep him occupied without having to defend a change in policy tack set against a highly uncertain background. This is not to say the Governor would not do what is necessary but, rather, it's coincidentally convenient that there are so many other matters to keep him gainfully employed.

A rough priority list for the Governor would look something like this:

- Ensure that the current review of the Reserve Bank does not result in the independence of the Reserve Bank being undermined;
- Restructure the Reserve Bank and hire the necessary staff;
- Look to change the culture of the central bank;
- Enhance the stability of the New Zealand banking sector by implementing such things as increased capital requirements;
- Oversee multiple enquiries into the broader financial services sector;
- Make sure the New Zealand banking sector can run independently from Australia;
- Work out how the new committee-based monetary policy decision making board will operate.

And, oh, dabble with monetary policy settings if absolutely necessary.

And it's not absolutely necessary now, in our opinion, because there is no smoking gun for tighter or looser policy. Certainly, if the gun wasn't heated in November it shouldn't be now. That's not to say that all the data have come out bang on expectation but just that the plusses and the minuses have broadly offset each other.

The following, relative to November, would argue for tighter monetary conditions:

- Non tradables inflation surprised to the upside and core measures of inflation trended higher;
- Partial indicators of the labour market indicate significant stresses are developing.

Tracking as expected are:

- The housing market, which is steady;
- Headline CPI came in near enough to expectations;
- So too has the labour market data;
- Dairy prices have bounced back to the levels assumed by the Reserve Bank; and
- Business sentiment has recovered to levels that no longer look threatening.

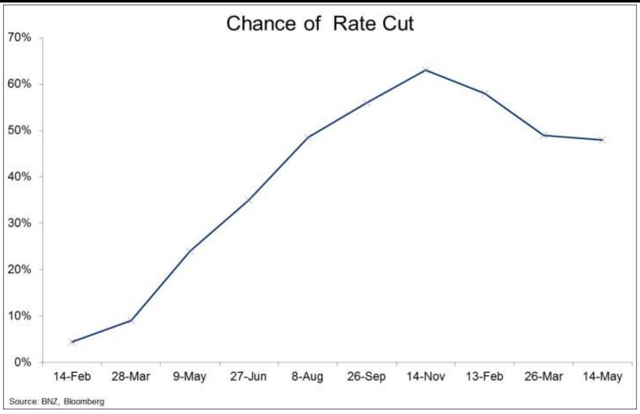
Arguing for looser monetary conditions:

- Q3 GDP came in well below expectations (0.3% actual against 0.7% forecast);
- Q1 headline CPI looks like it will come in below RBNZ projections thanks largely to falling oil prices;
- The TWI is currently sitting at 73.5. The RBNZ was looking for it to settle at 72.0. The variation is enough to knock around 0.2% off year ahead CPI forecasts;
- The global outlook and risks around it have deteriorated.

It's always difficult to know how one should weight these things but we believe that, on balance, the overall picture is insignificantly changed from November.

Most important of all, the RBNZ is charged with a dual mandate of price stability and maximum sustainable employment. It seems to us that both are being achieved. If anything, inflation is slightly shy of its target but the unemployment rate, and other job shortage indicators, caution that the current tightness in the labour market might be beyond sustainable.

Market Looking For Rate Cut



Last but not least, one wonders whether the RBNZ would have any great incentive to change current market pricing. While we think the market is overstating the likelihood of a rate cut (even more so post the labour market data), we can understand why it is doing so and why the RBNZ might be comfortable with it.

The market now sees a 65% chance of a rate cut within the next twelve months. We do not believe domestic developments justify this but we concede that if we are to get a shock any time soon it will be negative and, probably, emanate from offshore. To the extent that this is so, markets will want to price in a greater chance of a cut than a hike. We doubt the RBNZ would see any need for the market to fully price in a rate reduction but, equally, the Bank should be comfortable that an easing bias is being priced in without it needing to formally endorse it.

Putting all this together, we think the appropriate response from the RBNZ would be to leave its February MPS commentary and interest rate track as close as possible to that presented in November. While there must be word changes to reflect recent data, we think the key repetitions, in addition to no immediate change in the cash rate, should be:

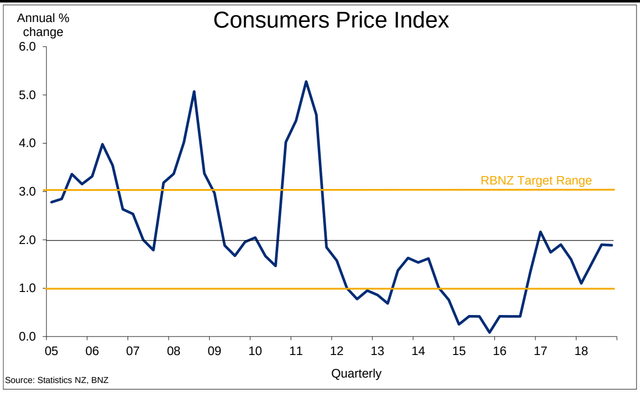
"We expect to keep the OCR at this level through 2019 and into 2020"

"We will keep the OCR at an expansionary level for a considerable period to contribute to maximizing sustainable employment, and maintaining low and stable inflation"

We believe that leaving the interest rate track unchanged would make sense but wouldn't be surprised if the implied first increase was delayed a quarter or two to prevent the model-driven end-point in the OCR track pushing higher as an extra quarter is added to the timeline. A higher short term TWI will also, in a mechanistic sense, help support this. Moreover, it would appear that the Reserve Bank dropped any reference to an equal chance of a rate hike as a rate cut when it received the surprisingly strong labour market data for Q3. Now that the data are no longer surprisingly strong, there's a chance that the equal footing sneaks back into the vernacular.

We'll wait to see exactly what the RBNZ says next week before formally reconsidering our own position but we have already acknowledged that there is no urgency to move rates in either direction. Accordingly, we may well end up delaying our own forecast implied tightening (which is really only a tightening bias) until 2020.

Target Met



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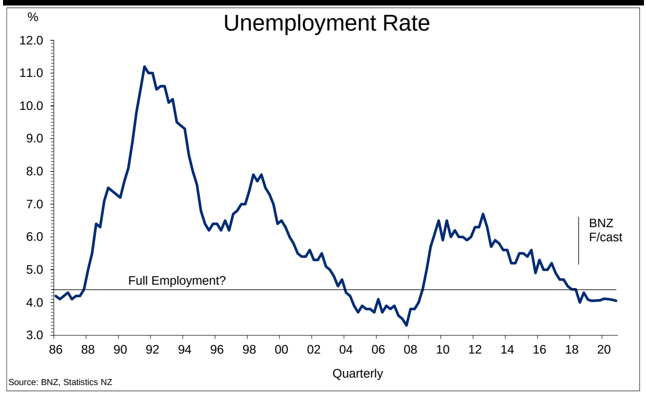

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