

# NEW ZEALAND ECONOMICS

## RBNZ MONETARY POLICY STATEMENT REVIEW

11 March 2010

### CONTRIBUTORS

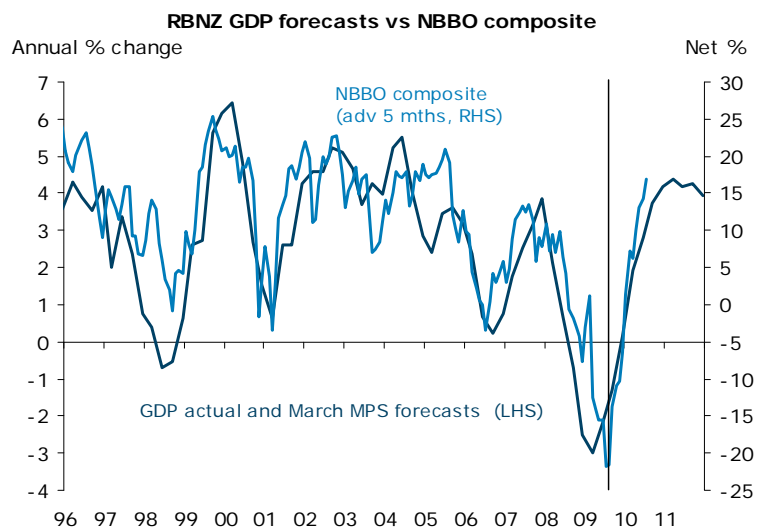
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## STICKING TO THE SCRIPT

### KEY POINTS

- The RBNZ left the OCR unchanged at 2.5 percent. It still expects to start the tightening cycle “around the middle of 2010”.
- Despite describing current activity as “patchy” and the recovery to be “sluggish”, the RBNZ still expects robust growth over calendar 2010 of 3.2 percent (annual average), led by household spending and residential investment. They have a 1 percent quarterly GDP profile from mid-year to achieve this, which appears at odds with the recent dataflow. We consider the Bank’s growth profile “optimistic” despite being consistent with business confidence readings.
- There are more nuances on the inflation front emerging, no doubt partly as a result of the Bank’s view that potential growth is lower, meaning any spare capacity will be soaked up at a faster rate – and especially with labour being preferred over capital during the first legs of the recovery process. While the Bank still expects headline inflation (ex-ETS) to track within the target range over the medium-term, the word “comfortable” from their January review has been omitted.
- For the first time, the Bank explicitly mentions that higher bank funding costs will reduce the extent of future OCR increases, implicitly resulting in a lower neutral policy rate which is closer to 5 than 6 percent. We concur. Their 90-day profile is around 30-40bps lower from mid-2012 compared to December.
- The Bank’s gameplan at present appears to be one of being prepared to move early but gradually, ultimately delivering a cycle of lower magnitude. We concur with the spirit of this, but given our different view of the recovery path, have pencilled in a slightly later start.



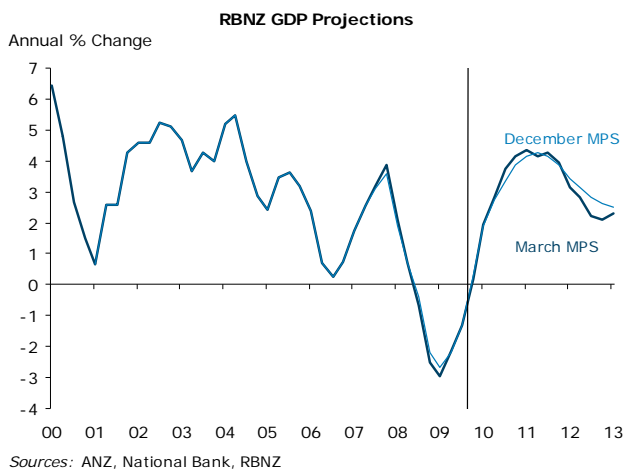
Sources: ANZ, National Bank, RBNZ, Statistics NZ

# ECONOMIC REVIEW

## ASSESSMENT

The RBNZ has largely stuck to their script, expecting the recovery to gather sufficient momentum as to warrant the removal of policy stimulus by the middle of 2010.

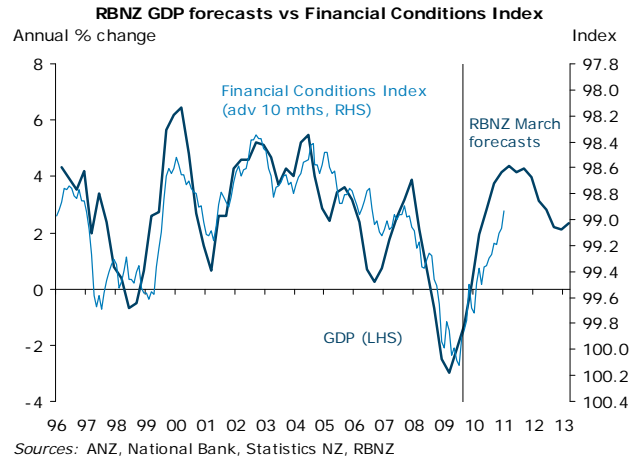
The RBNZ remains relatively bullish about the growth outlook, which remains remarkably similar to their December *Monetary Policy Statement* view. Annual average GDP growth of 3.2 percent and 4.2 percent is forecast for calendar 2010 and 2011 respectively. The RBNZ are keen to emphasise this rebound as relatively modest, considering the extent of the downturn. Nonetheless, reading between the lines, the Bank expects the recovery to be self sustaining by the middle of the year, with quarterly GDP growth rates of over 1 percent.



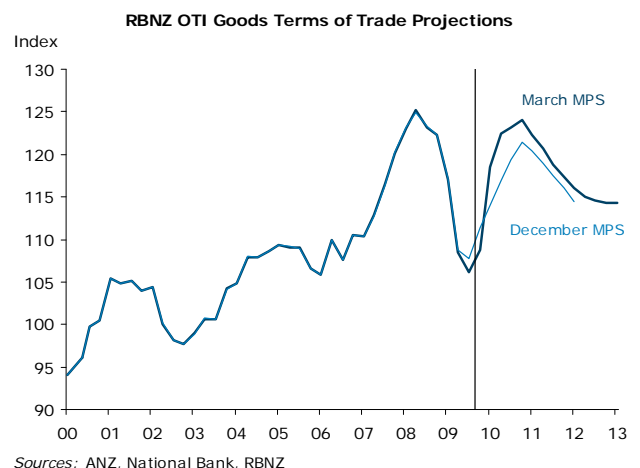
This is somewhat at odds with the general spirit of the *Statement* that makes references to activity as “patchy both within and across sectors”, and the overall pace of recovery as “sluggish”. But growth is still growth, although there is also the base effect at work, which the RBNZ notes. However, the RBNZ’s expectations that the rebound is to be broad based across sectors, and that private consumption and residential investment will support a recovery in domestic demand, seems at odds with the recent dataflow.

We are more circumspect in regards to the near-term growth outlook. In our eyes, there are still significant headwinds centred around commercial property, rural sector deleveraging and whether elevated business confidence will manifest into actual hiring and investment. So while the RBNZ’s growth projections are consistent with the National Bank business confidence readings, at this stage we are putting more weight on our financial

conditions index, which is pointing towards a more modest recovery.



The RBNZ sees the global outlook as having evolved slightly more strongly than in the December *MPS*. The global expansion remains patchy and although risks have increased, they are not as extreme as during the global financial crisis. Upside risks are noted as the potentially more likely. This is seen as helping to hold NZ’s major export commodity prices at current high levels, and see the terms of trade recover to close to its mid-2008 peak by the end of this year. No doubt this is one factor which is giving the RBNZ confidence in their growth outlook, alongside the recent declines in the New Zealand dollar. We agree with this, but have this flowing into 2011 as opposed to 2010.



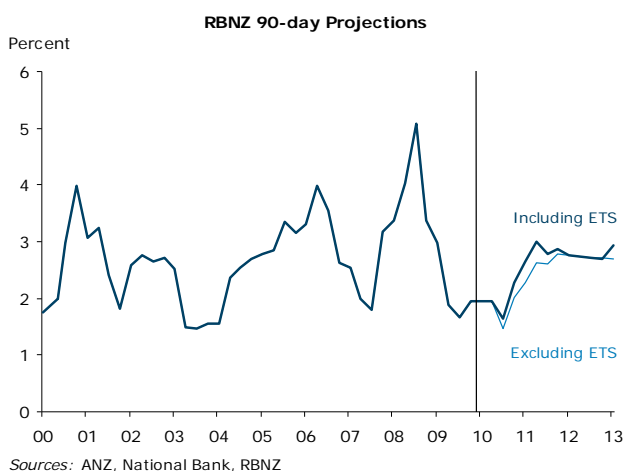
Today’s *Statement* was noteworthy for providing more emphasis on the inflation outlook. The short-term outlook is for inflation to move close to the top of the 1 to 3 percent band, even when the effects of the forthcoming Emissions Trading Scheme (ETS) are removed. On the face of it, this does not give the RBNZ much inflation headroom. However, the medium-term inflation

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outlook is still expected to remain within the target range, although the term “comfortable” from their January Review has been omitted.

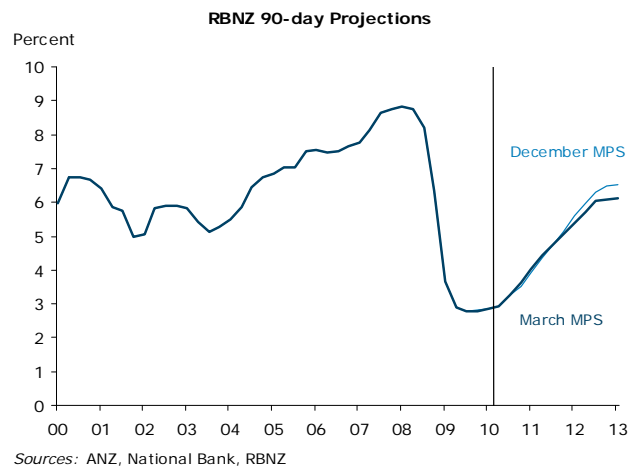
**The Bank is well aware that there will be greater noise in the forthcoming inflation numbers than usual** given prospective increases in administrative charges (not to mention any changes to GST, which was omitted since it is not yet official government policy). The Bank will look through the first round inflationary effect, but will remain on guard for any possible effects on inflation expectations and wage and price setting behaviour.

**Business investment is expected to lag the cycle, partly as a consequence of higher business funding costs and the lack of availability of credit.** A consequence of lower investment is lower productive potential, with the RBNZ revising down their estimates of trend growth to around 2 to 2¼ percent over the forecast horizon. **This will have consequences for the amount of spare capacity going forward, and is no doubt one of the reasons for the increased nuances regarding inflation in today’s Statement.** Simply put, the Bank will view any pick-up in activity (no matter how sluggish relative to history) as eating into spare capacity faster and therefore resulting in upward inflation pressure earlier. Significantly, the early stages of the recovery are seen by the Bank as being met by labour demand as opposed to business investment. The Bank forecasts non-tradable inflation to return towards 3 to 3¼ percent by mid-2011.



**For the first time, the Bank emphasised the increased cost of funding as resulting in less need for the RBNZ to move more.** This is reflected in a lower 90-day profile at the end of the forecast horizon, where it settles at around 6 percent, and is 30-40bps lower than the December

projections from mid-2012. With the Bank’s view that the higher funding cost will persist, and together with the positively shaped yield curve and a shortening in mortgage duration, these point to a lower neutral policy rate view, which is consistent with our own assessment.



**On balance, despite the RBNZ sticking to their “middle of 2010” stance, we continue to see the tightening cycle starting in Q3.** A key reason for this is that we have a different view on how the economy will evolve over the first half of this year, and how we see fiscal policy interacting over the coming years. We believe the conditions for a self sustaining recovery are starting to move into place, but they are not going to be apparent by the time of the June *Monetary Policy Statement*. This is particularly so in regard to employment and investment. That said, the RBNZ’s GDP forecast for Q4 2009 (at 0.6 percent) and CPI forecast for Q1 2010 (at 0.3 percent) look on the low side. So while we see the potential for partials to undershoot the RBNZ’s core GDP trajectory over the first half of 2010, there are some noteworthy significant near-term releases that will push against this view. **Nonetheless, we continue to view the credit growth numbers as the key gauge to watch in regard to the tightening cycle.** They remain subdued and are still not showing much sign of a pick-up.

Stepping beyond the timing of the first hike, there are two other issues.

**The first is the magnitude.** We have pencilled in a 25bp move to start the tightening cycle, although we believe at some stage the RBNZ is going to have to deliver a 50bp move, for credibility as much as anything else. But with likely tax changes to housing in the May *Budget*, it is hard to envisage a case for an aggressive move early on. That said, we are closely watching for evidence that

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households and firms are reverting to their “previous borrowing and lending behaviour”, which would require a more aggressive stance. But as the RBNZ notes, such a risk will likely take years to develop.

**Second, we agree with the spirit of the RBNZ’s assessment that the combination of curve shape, funding cost persistence and mortgage duration results in a lower end-point for policy.** Five percent seems a nice round number at present, and we expect the movement towards this rate to be somewhat staggered as opposed to sequential.

We are somewhat surprised the RBNZ chose to maintain the mid 2010 rhetoric given that it is already March. But the spirit of the assessment really centres on rates moving up, but with a lower endgame. In that regard, we pretty well concur with the overall message from today’s *Statement* despite our more reserved assessment for 2010.

#### FINANCIAL MARKET IMPLICATIONS

Despite the RBNZ affirming their “middle of 2010” stance, the market latched on to the lower neutral rate view, sending the NZD lower and swap yields around 3-4bps lower across the curve. We expect the market to maintain their pricing for a June start to the tightening cycle, with the upcoming dataflow to dictate. There still looks the potential for the market to continue reassessing how far rates are likely to move up given the 150 basis point funding cost wedge that is likely to persist.

RBNZ MARCH 2010 MPS PROJECTIONS (DECEMBER 2009 MPS IN BRACKETS)						
	GDP (QoQ)	GDP (YoY)	CPI (QoQ)	CPI (YoY)	90-day	TWI
Q4 2009	0.6 (0.6)	0.2 (0.3)	-0.2	2.0	2.9 (2.8)	64.5 (66.5)
Q1 2010	0.9 (0.8)	1.9 (1.9)	0.3 (0.1)	2.0 (1.8)	2.9 (2.8)	64.5 (66.5)
Q2	1.1 (0.9)	2.8 (2.7)	0.5 (0.4)	1.9 (1.6)	2.9 (2.9)	64.4 (66.6)
Q3	1.1 (1.0)	3.8 (3.3)	0.9 (0.6)	1.5 (0.9)	3.3 (3.3)	64.2 (66.2)
Q4	1.0 (1.1)	4.2 (3.9)	0.4 (0.3)	2.0 (1.4)	3.6 (3.5)	64.1 (65.5)
Q1 2011	1.1 (1.1)	4.4 (4.2)	0.5 (0.5)	2.3 (1.8)	4.0 (3.9)	63.7 (64.5)
Q2	0.9 (1.0)	4.2 (4.3)	0.9 (0.8)	2.6 (2.3)	4.4 (4.4)	63.1 (63.4)
Q3	1.2 (0.9)	4.3 (4.2)	0.8 (0.9)	2.6 (2.5)	4.7 (4.7)	62.5 (62.2)
Q4	0.7 (0.8)	4.0 (3.9)	0.5 (0.4)	2.8 (2.6)	5.0 (5.1)	61.9 (61.2)
Q1 2012	0.3 (0.7)	3.1 (3.4)	0.5 (0.5)	2.8 (2.6)	5.4 (5.6)	61.4 (60.5)
Q2	0.6 (..)	2.8 (..)	0.9 (..)	2.7 (..)	5.7 (..)	60.7 (..)
Q3	0.6 (..)	2.2 (..)	0.8 (..)	2.7 (..)	6.0 (..)	60.2 (..)
Q4	0.6 (..)	2.1 (..)	0.5 (..)	2.7 (..)	6.1 (..)	59.9 (..)
Q1 2013	0.5 (..)	2.3 (..)	0.5 (..)	2.7 (..)	6.1 (..)	59.3 (..)

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**FULL TEXT OF THE OCR ASSESSMENT**

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

The New Zealand economy is recovering broadly as expected and growth is predicted to pick-up further through 2010.

Trading partner activity has recovered a little faster than expected. Currently, growth is strongest in China, Australia, and emerging Asia, but is much more muted in other trading partners. At the same time, risks around the global outlook have increased, although not to the extreme levels seen at the height of the crisis.

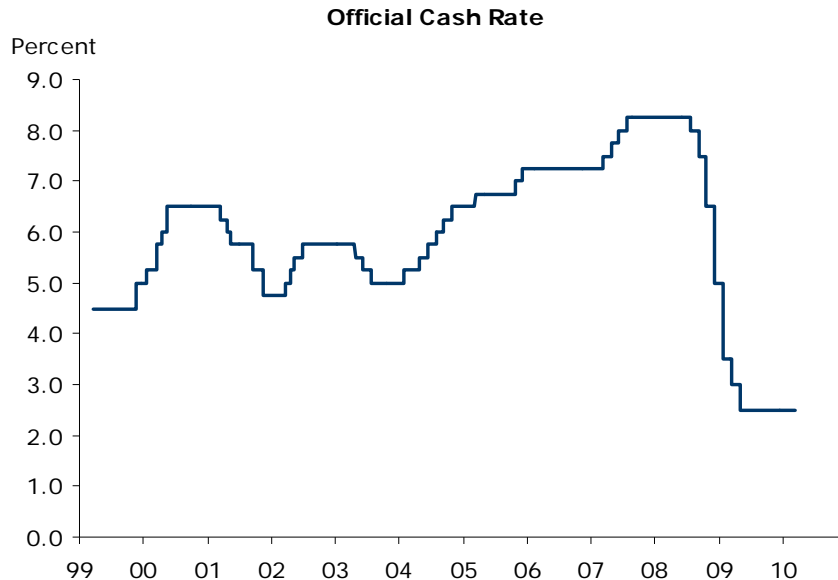
We estimate the New Zealand economy grew at a stronger pace in the December and March quarters than in the prior two quarters. Looking forward, while growth is expected to increase to about 4 percent next year, this is subdued relative to previous recoveries.

Policy stimulus and improved consumer confidence have seen a pick-up in household spending. That said, households are still cautious with house sales and credit growth remaining subdued. Business spending is weak despite much improved confidence.

Annual CPI inflation is currently at 2 percent, and is expected to track within the target range over the medium term. In the short term, implementation of the amended Emissions Trading Scheme and increases in ACC charges will push CPI inflation toward the top of the target range.

Higher bank funding costs have reduced the level of stimulus that would normally be associated with any given level of the OCR. We expect these costs to persist over the projection reducing the extent of future increases in the OCR. Fiscal consolidation would also help reduce the work that monetary policy might otherwise need to do.

We continue to expect to begin removing policy stimulus around the middle of 2010.



Sources: ANZ, National Bank, RBNZ

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