

# Economic Review

## New Zealand

28 January 2010

### RBNZ Official Cash Rate Review

#### Key points

- > The RBNZ left the OCR unchanged at 2.5 percent as widely expected.
- > The assessment was largely similar to December's, with a slight firming in tone on a mid-year start to the tightening cycle, but balanced by inserting the word "*comfortably*" into the medium-term inflation assessment.
- > The upcoming dataflow, particularly credit growth and the labour market, will continue to be influential on the exact timing of the rate hike. We continue to see June as the start.

#### Assessment

**Today's OCR assessment itself was short and to the point.** There was never any doubt that the RBNZ would keep the Official Cash Rate (OCR) steady at 2.5 percent. What the market was looking out for was any change in the Bank's stance from December, and whether the "*middle of 2010*" phrase regarding rate hikes would be altered. Taken literally, the middle of 2010 could mean anytime from April to September, hence the divided assessment on when the first hike will be.

**There was a slight firming in tone**, with the Governor noting that "*we would expect to begin removing policy stimulus around the middle of 2010*", compared to December's "*conditions may support beginning to remove monetary stimulus...*".

**Implicitly, the Bank seems more confident of the recovery that is currently underway.** The December assessment started off by noting that "*The New Zealand economy continues to recover but there remains considerable uncertainty about the durability of the expansion*". This has firmed to "*The New Zealand economy continues to recover.*" This suggests that despite the weaker Q3 GDP outturn, the Bank still sees the economy expanding by around 3 percent this calendar year, in line with forward indicators. But there are still some notes of caution over the global scene, acknowledging that "*sustained growth throughout our trading partners is not assured*" and that many are still facing "*impaired financial sectors and overall activity still reliant on policy support.*" Indeed, recent indigestion across global equities highlights the frailty and uncertainty in some areas in regards to the global scene. On the domestic front, the Bank notes a pickup in household spending (another firming point from December) but also noted that households remain cautious, credit growth is subdued and business spending remains weak (in line with December).

#### **We concur with the Bank's overall assessment.**

Momentum is building. But there remain missing links towards a normal cyclical and resource sapping recovery. Critical here is the outlook for employment and investment, with credit growth a key proxy for confidence in both. Hence, while things are clearly improving and the economy is gaining momentum (with Q4 GDP looking very strong and consumer confidence up in January), there is still some way to go, especially given the starting point. Remember – the economy has recorded sub-trend growth for seven consecutive quarters (five of them contractions). Improving prospects need to be read in view of this, and the RBNZ needs to be comfortable that the scene is set for more than one quarter of strengthening growth. We, like the RBNZ, believe this should be apparent by mid-year.

**Importantly, the RBNZ's inflation outlook has altered slightly, from being merely "*within*" the target range to now "*expected to track comfortably*" within the band.** References to inflation falling below the mid-point of the band until mid 2011 have been dropped, but in our minds the inclusion of the word "*comfortably*" is the more relevant change. And this is even after accounting for the 0.4 percentage point impact of the government's emissions trading scheme on inflation, which were not factored into the Bank's December projections.

**The inclusion of the word "*comfortably*" into the inflation assessment appears to carry two important connotations** (although we note it may also have been designed to mitigate an adverse reaction to inflation not falling below 2 percent until mid 2011). Firstly, do not get hung up on near-term CPI prints (i.e. Q1 CPI which is being released in April). Their focus is rightly on the medium-term picture, hence our fixation with labour market trends with next week's Q4 QES and HLFS prints being important. Both are expected to be weak, but anecdotes suggest a turning point for the current quarter. This is the evidence the RBNZ needs to see

in the hard data. The HLFS for Q1 is not out until May, after the April OCR *Review*, which leaves us biased towards a June hike. Second, it implies potentially a slower paced tightening cycle. If inflation is expected to remain comfortably within the target band, then the process of policy normalisation could take place gradually. This appears to suggest 25 basis points moves as opposed to something larger. This has us thinking, but we'd prefer to maintain our bias for a 50 basis point move at the start of the cycle. The reasoning is simple: it's a question of credibility and historical experience. So while we are inclined to a gradual and multi-stepped tightening cycle, we'll maintain our inclination towards the first being a 50, but 25s thereafter. We continue to see June as the start of the tightening cycle.

**Financial Market Implications**

Today's OCR assessment had something for everyone, and was clearly designed to have minimal impact on the market. Judging by the market reaction, with swaps and the NZD largely unmoved, the RBNZ has been successful and can give themselves a pat on the back. The upcoming dataflow will remain critical as would be expected, and particularly relative to the RBNZ's December projections. We continue to pay close attention to credit growth trends. Central banking in 2010 appears relatively straight forward: if credit growth picks up, remove excess liquidity. If it remains stagnant, maintain supportive conditions.

**Full text of the OCR assessment**

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

Reserve Bank Governor Alan Bollard said: "The outlook for the New Zealand economy remains consistent with the projections underlying the December *Monetary Policy Statement*.

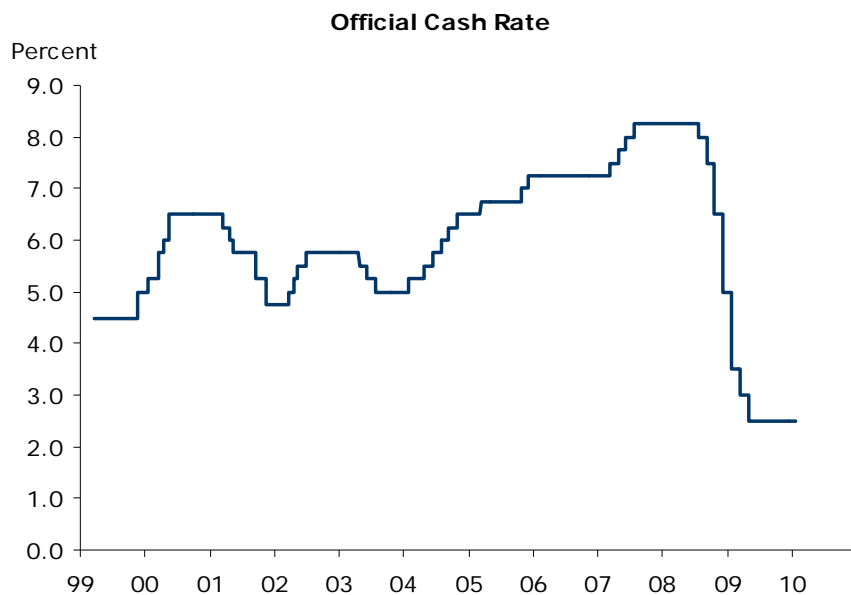
"Global activity continues to recover, helping push New Zealand's export commodity prices higher. Economic growth is most apparent in China, Australia, and emerging Asia. However, sustained growth throughout our trading partners is not assured, with many still facing impaired financial sectors and overall activity still reliant on policy support.

"Similarly, the New Zealand economy continues to recover. Policy stimulus and improving export earnings have seen a pickup in household spending. That said, households remain cautious, with credit growth subdued. Business spending remains weak.

"Annual CPI inflation is currently at the centre of the target band, and is expected to track comfortably within the band over the medium term.

"The economy is being assisted by both monetary and fiscal policy support. As growth becomes self sustaining, fiscal consolidation would help reduce the work that monetary policy might otherwise need to do.

"If the economy continues to recover in line with our December projections, we would expect to begin removing policy stimulus around the middle of 2010."



Sources: ANZ, National Bank, RBNZ



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