

Economic Review

New Zealand

30 July 2009

RBNZ July OCR Review

Key points

- > **The RBNZ left the OCR unchanged, in a short and concise statement, but remained dovish and left the door open to further cuts. The statement, in fact, was more dovish than expressed in June.**
- > **The statement was clearly directed at external aspects (currency) with no mention of (upside) domestic factors, such as migration.**
- > **There was no mention made of prudential policy measures, but we expect them to play a substantial role going forward.**
- > **Our core views remain unchanged. We continue to see policy remaining on hold well into 2010, and the currency as the relative price mechanism that must ultimately adjust lower.**

Assessment

A no change decision was widely expected, but today's statement was clearly directed at the currency. The major focus of the market was not really on what the OCR would be; there was a general expectation that this would be left unchanged at 2.50 percent (as it was). The focus was clearly on what would be said to accompany the decision. The comments were still unequivocally dovish, and in fact even more dovish than expressed in the June *Monetary Policy Statement*. The major difference was the removal of comments on the "upside opportunities" from the housing market and net migration and instead concentrated squarely on financial conditions (the currency in particular) and risks present in the external sector.

While the RBNZ expects the economy to begin to grow again shortly, they are clearly concerned about the sustainability of any recovery. Comments towards the economic outlook remain subdued, "*Despite signs of a levelling off in economic activity, the economy remains weak*", "*...we expect a patchy recovery...*", "*...it will be some time before growth returns to healthy levels.*" They acknowledged that economic activity has evolved generally in-line with their expectations but where it goes from here is heavily dependent on a further easing in financial conditions, particularly the currency.

A clear easing bias remains, but with more beef. Importantly, the Bank left the final paragraph largely unchanged. Explicitly, they still expect to "*...keep the OCR at or below the current level through until the latter part of 2010.*" However, the Bank went further noting that if

financial conditions do not ease then "*...we would need to reassess policy settings.*"

While we agree with the RBNZ's nuances towards the currency, the strategy is not risk free. One instrument, one target – namely inflation. It is mathematically impossible to do more. Jawboning must ultimately be matched by action, and such action risks stoking the housing market further. This is where monetary policy is in a difficult situation. A lower OCR (and currency to boot) is required to support the tradable and rural sectors. But the reciprocal is needed for areas such as Auckland, where the housing market is clearly showing signs of life. At present it is evident that the former represents the greater [systemic] risk to the aggregate economy and hence the sharp talk in today's statement. We are in little doubt the end-game here is ultimately a greater use of prudential policy as a means of assisting the relatively blunt nature of the OCR.

A key issue from here is whether we see the RBNZ delivering on its rhetoric, and following through if they don't get the adjustment they require.

In the absence of a further aggressive relapse in global conditions or systemic dislocation locally, we struggle to see the OCR actually moving lower. The RBNZ's June *Monetary Policy Statement* detailed a scenario of an ongoing build-up in imbalances that involved a combination of a high currency, such as we have currently, and a rejuvenated housing sector. The end-game to that scenario was a larger current account deficit and deeper economic correction down the track, along with lower living standards on average over the medium term. Dr Bollard hinted at this type of scenario in a recent speech where he cautioned of

households “resuming their ‘borrow and spend habits’ before bringing their debt levels back to more prudent levels.” While responding to the strong currency is one aspect to this cycle and mitigating such a scenario is unfolding, the mechanism – lower rates – risks inflaming the other pocket – the housing sector. Once again this disconnect reinforces to us the likelihood of prudential policy playing a greater role in the future.

Implications

Our core views remain unchanged. We continue to see policy remaining on hold well into 2010, and the currency as the relative price mechanism that must ultimately adjust lower. The latter is likely to remain frustrating unless a clear USD trend unfolds. We expect continued jawboning from local policymakers. The longer the elevation in the currency remains, the greater the potential reciprocal adjustment. If the RBNZ does in fact follow through and cut the OCR, given continued concerns about the currency and flow-on to the tradable sector, then we suspect this will need to be matched by prudential measures, unless the former is systemic related. Hence, we see the latter as being a potential flag as to the likelihood of the former.

Full text of the July OCR Review

The Official Cash Rate (OCR) will remain unchanged at 2.50 percent.

Reserve Bank Governor Alan Bollard said: “Despite signs of a leveling off in economic activity, the economy remains weak. We continue to expect to see a patchy recovery get underway toward the end of the year, but it will be some time before growth returns to healthy levels.

“The outlook remains highly uncertain. New Zealand’s merchandise exports are heavily weighted to soft commodities. As a result, New Zealand has not benefited to any significant extent from the rebound that has occurred recently in global hard commodity prices.

“Overall economic growth is evolving broadly in line with our forecasts in the June *Monetary Policy Statement* as the low OCR and stimulatory fiscal policy take effect. However, looking forward the level of the New Zealand dollar and wholesale interest rates are higher than assumed in our forecasts. The level of the dollar in particular, is not helping the sustainability of future growth, and brings with it additional economic risks.

“The forecast recovery is based on a further easing in financial conditions. If this easing does not occur, the forecast recovery could be put at risk. In these circumstances we would reassess policy settings.

“Annual CPI inflation is currently well within the target band and it is expected to track comfortably within it over the medium-term.

“We consider it appropriate to continue to provide substantial monetary policy stimulus to the economy. The OCR could still move modestly lower over the coming quarters. We continue to expect to keep the OCR at or below the current level through until the latter part of 2010.”

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- Financial Markets Operations Association; and
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- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

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This document has been prepared by ANZ National Bank Limited.

ANZ (part of ANZ National Bank Limited), Level 7, 1 Victoria Street, Wellington 6011, New Zealand Phone 64-4-802 2000 Fax 64-4-496 8639 <http://www.anz.co.nz> e-mail ecnmcs@anz.com

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