

NEW ZEALAND ECONOMICS

RBNZ OCR REVIEW

29 July 2010

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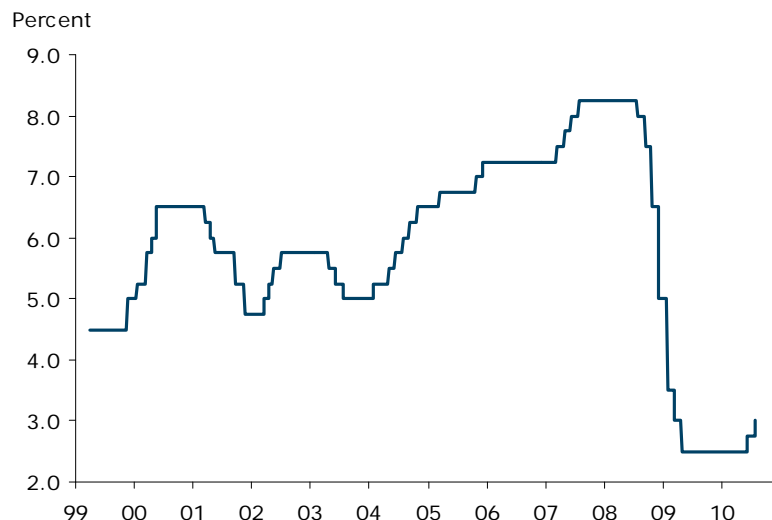
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RBNZ HIKES BUT TONES DOWN POLICY OUTLOOK

KEY POINTS

- The RBNZ increased the OCR by 25 basis points today to 3.00 percent as expected. The Bank has, by-and-large, stuck to the script in terms of noting the need to reduce the level of extraordinary policy stimulus.
- But while sticking to their “removal of monetary policy stimulus” script, the tone was a bit more downbeat compared to their June assessment.
- The RBNZ noted numerous downside risks: “future prospects for (global) growth have deteriorated”, “domestic demand is subdued”, “slowing net migration will act to further dampen consumer spending”. However, these are still couched within a view of “respectable near-term GDP growth”, somewhat more sedate than the “broad-based” recovery they expressed in June.
- The RBNZ is now indicating that the pace and extent of further OCR increases will be more moderate than their June projections (which had the 90-day rising towards 6.1 percent by late 2012).
- We believe a hike in September is still odds-on, but ascribe only a 60 percent chance on it. We remain of the view that Q4 will see a pause in the tightening cycle. This seems to correctly balance the softening seen of late and the risk profile, against a taut rubber band in terms of where the OCR sits relative to neutral. The OCR is still biased upwards over time. But the path to normalisation will be a staggered and elongated one.

RBNZ Official Cash Rate



Sources: ANZ, RBNZ

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COMMENT

Today's decision by the RBNZ to increase the OCR by 25 basis points to 3.00 percent was widely expected. On the face of it, it looks like the RBNZ was sticking to their June script of further removing policy stimulus. Indeed, the first paragraph of the press release noted that "While the outlook for economic growth has softened somewhat, it is still appropriate to continue to reduce the extraordinary level of support implemented during the 2008/09 recession."

However, the overall tone of the assessment was more downbeat. Specifically, in June, the RBNZ described growth as becoming more broad-based. While the RBNZ is still predicting "respectable near-term GDP growth", they note that domestic demand is subdued, households are cautious, business investment is low and corporate lending is subdued. And for the first time, the RBNZ mentioned the recent slowing in net migration as acting to further dampen consumer spending.

It seems that the RBNZ is banking on manufacturing strength and ongoing strong forestry exports to drive growth and offset domestic demand weakness. While there is no doubt that the level of manufacturing confidence remains high, we question whether growth from that sector will be strong enough in light of the slowing in global growth and the end of the inventory rebuilding cycle. There is also a risk that the exponential growth in New Zealand's forestry exports will taper off at some stage in the near term. While the RBNZ noted that trading partner growth has turned out stronger than they had predicted, they acknowledged that future growth prospects have deteriorated. Our travels are detecting a softening in demand from markets that have shown strong growth over the past year.

The RBNZ looks to be eying the NZ dollar. The Bank noted that the recent appreciation has been inconsistent with the softening domestic outlook and moderation in commodity prices. We agree.

In a change of their future policy stance, the RBNZ now note that the pace and extent of further OCR increases is likely to be more moderate than was projected in June. This is in line with our long held view that the tightening cycle was not going to be a straight line affair, and that it will be a staggered cycle.

The Bank made two references to the low level of the OCR ("extraordinary level of policy support" and "the level of the OCR is still supportive of economic activity"). Our read on this is simple: rates do indeed need to head up over time as the rubber band is still taut in terms of where the OCR is relative to neutral. But the RBNZ looks to be mindful of how rate hikes are expressed (which are never well received), describing it as winding down stimulus rather than tightening policy. Or to use RBNZ Governor Alan Bollard's truck driver analogy, they are reducing the pressure on the accelerator as opposed to pushing on the brakes. **To us, this means the RBNZ remains committed to further removing policy stimulus as "Plan A".** But clearly this remains contingent on economic and financial developments, and our travels are detecting a softer tone than the "respectable growth" picture the RBNZ is portraying.

ASSESSMENT

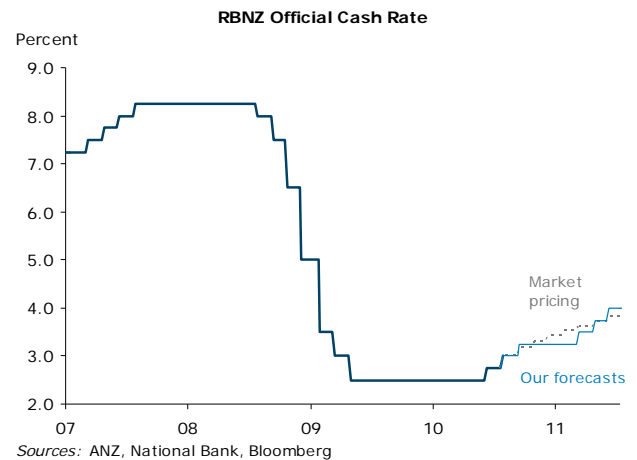
Within the soft overall tone of today's RBNZ assessment, we still detect some elements of belligerence. Firstly, the RBNZ has included references to the extraordinary level of policy support not once, but twice, as noted above. Some of this is no doubt to remind households and firms that the OCR was cut to record low levels in the face of a severe recession. With the economy now recovering, subdued as it may be, such low OCR settings are no longer warranted. But policy will remain supportive still, just less so. Secondly, the RBNZ has chosen once again to reinforce the importance of firms and households to not adapt their pricing behaviour in response to the one-off jump in inflation as a result of the GST increase on 1 October. Some of the policy stimulus removal can be seen as insurance against this occurring.

At this stage, we expect the RBNZ to deliver one more hike in September (subject to no material deterioration in domestic or global prospects), then pause to assess the landscape. The OCR is still biased upwards over time, as the RBNZ seeks to get rates closer to, but still below, neutral. However, the path to normalisation will be an elongated one with pauses along the way.

Two events loom as critical in the domestic calendar: the Fonterra online auction and the Q2 HLFS employment data, both out next week. The employment data is going to be a lottery, and we

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expect some correction from the large fall in the unemployment rate in Q1. If the upward correction in the unemployment rate is larger than we expect, alongside a further marked moderation in the Fonterra auction, then a September hike could turn into a line ball call. At present we put a 60 percent probability on a hike in recognition of what looks to be the RBNZ's "Plan A". But if the soft anecdotes we have been receiving of late extend into August, we will review our September call.



FULL RBNZ PRESS RELEASE

The Reserve Bank today increased the Official Cash Rate (OCR) by 25 basis points to 3.0 percent.

Reserve Bank Governor Alan Bollard said: "While the outlook for economic growth has softened somewhat, it is still appropriate to continue to reduce the extraordinary level of support implemented during the 2008/09 recession.

"The world economy continues its fragile recovery. Trading partner growth has turned out stronger than we predicted, however, future prospects for growth have deteriorated. While still at high levels, our commodity prices have moderated.

"In New Zealand, domestic demand is subdued. Households are cautious, with retail spending growing only modestly, housing turnover in decline and household credit growth weak. While this caution has been evident for some time, the recent slowing in net immigration will act to further dampen consumer spending. Business investment remains very low, with corporate lending continuing to be subdued.

"The New Zealand dollar has appreciated in recent weeks. This appreciation is inconsistent with the softening in New Zealand's economic outlook and moderation in our export commodity prices.

"Overall, we continue to predict respectable near-term GDP growth, with manufacturing confidence remaining elevated and forestry exports continuing to expand. An eventual recovery in business investment will assist growth over the medium term.

"Annual CPI inflation has been near 2 percent for the past five quarters. As the economy grows, inflationary pressures are expected to pick up.

"Given this, some further removal of monetary policy stimulus is appropriate at this stage. Even after today's move, the level of the OCR is still very supportive of economic activity. The pace and extent of further OCR increases is likely to be more moderate than was projected in the June *Statement*. Our policy assessment will be continually reviewed in light of economic and financial market developments.

"The coming increase in the rate of GST and other government-related price changes are likely to temporarily push annual CPI inflation above 3 percent. The Bank does not expect this price spike to have a lasting impact on inflation. However, the price and wage setting behaviour of firms and households will be monitored for evidence of any increase in inflation expectations."

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