

NEW ZEALAND ECONOMICS

RBNZ MONETARY POLICY STATEMENT REVIEW

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POLICY STIMULUS REMOVAL BEGINS

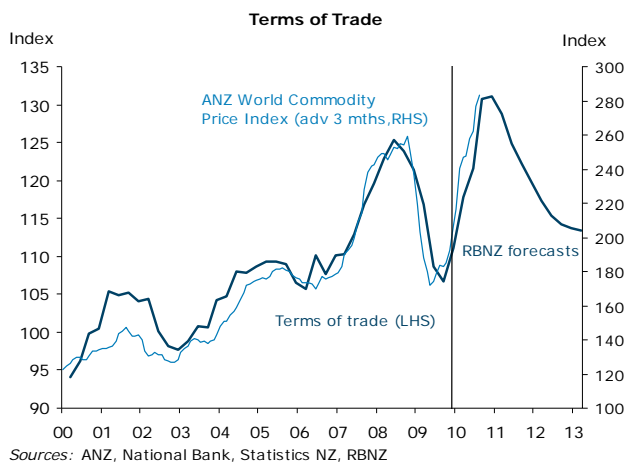
KEY POINTS

- The RBNZ increased the OCR by 25 basis points to 2.75 percent as widely expected.
- The overall tone of the Monetary Policy Statement was generally more upbeat, noting that growth is robust and becoming more broad-based.
- The RBNZ's 90-day projections show a slow and steady trajectory of higher rates, with the endgame around 6 percent for the OCR.
- Elevated funding costs, a higher proportion of borrowers on floating rates and higher long-term interest rates are once again noted as mitigating the extent to which the OCR should need to rise.
- Three key judgements underpin the RBNZ's forecasts: inflation expectations remain anchored despite a temporary blip in inflation to 5 percent; the domestic economy continues to deleverage; and sovereign risk concerns do not spill over significantly beyond Europe. While the count is two to one in favour of the upside risks, the downside is the more prevalent for now. The former looks to be late 2010 and 2011 issues. Hence there will remain considerable uncertainty over the pace at which policy support will be removed, with the RBNZ also explicitly noting that *"further removal of stimulus will be reviewed in light of economic and financial market developments."*
- So while the removal of policy stimulus has begun, we still expect the pace to be gradual, and the endpoint for the OCR will be lower compared to previous cycles.
- We still see three further 25bp hikes taking the OCR to 3.5 percent by October, followed by a pause to assess things. The risk is global events see an earlier pause. Beyond that we see the endgame for the OCR somewhere around 5 percent, which is our assessment of where the new neutral rate resides. History tells us rates will overshoot neutral, but given the lingering after-effects of the global financial crisis, such an endgame seems more likely to be five years out.

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ASSESSMENT

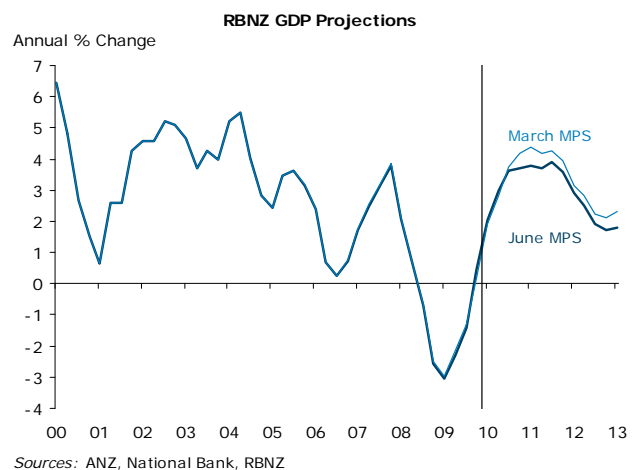
In raising the OCR by 25bps to 2.75 percent today, the RBNZ was basing its decision on what it knows. And that is a New Zealand economy that continues to recover from recession (albeit at a slower pace compared to past recoveries) and a pending huge income boost from record terms of trade later this year. With commodity prices at record high levels and Fonterra announcing a higher milk price forecast for the 2010/11 season, along with an improving labour market and a strong overall trading partner growth outlook, the RBNZ felt that the economy no longer needed a cash rate of 2.5 percent. Hence, the decision to start removing policy stimulus today.



The general spirit of the statement and the projections are marginally more upbeat, despite the overall growth profile being slightly lower compared to the March *Statement*. GDP growth is described as robust over the projection even as policy stimulus is withdrawn, with the recovery now seen as being more broad-based. This is despite consumer spending expected to remain somewhat contained. The general tone is more upbeat than those expressed by the Bank of Canada in their policy assessment earlier this month.

The tone of the policy assessment was pitched in terms of removing the degree of policy stimulus. Given policy support and strong commodity prices were providing considerable stimulus to the economy, it seems appropriate to lessen the extent of policy stimulus. However, the RBNZ are clearly mindful of the potential risks of global developments worsening, and have made future tightening more conditional on the economic outlook, noting that *“further removal of stimulus will be reviewed in light of economic and financial*

market developments.” This gives the RBNZ the utmost flexibility in case global conditions deteriorate rapidly. However, in our view, **it will require a significant deterioration in the sovereign debt crisis, spilling over into trading partner growth and the financial system, for the RBNZ to pause in July.** We continue to monitor the ability for banks to access global capital closely, along with the price.



Recent global market turmoil is acknowledged, but this has been treated as a risk at this stage. The RBNZ's judgement is that the main impact on New Zealand will be via continued upward pressure on bank funding costs, though not anywhere near what was experienced following the Lehman collapse. At present, the Bank sees limited real economic flow-on beyond Europe into other regions. We think the risk of this is pretty material, but can be characterised in terms of probability as opposed to certainty.

Once again the RBNZ made reference to higher funding costs, higher long-term rates and a greater proportion of borrowers on short-term rates. While they appear to have no precise figure on what this implies for the neutral OCR, in our view it effectively gives monetary policy about 100bps of additional tightening, which reinforces a lower end point for the OCR.

The RBNZ's projections contain three key assumptions:

- the one-off boost to inflation does not seep into inflation expectations;
- the domestic economy continues to deleverage; and
- trading partner growth is not materially impacted by offshore sovereign risk concerns in Europe.

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As the RBNZ note, the policy outlook would be revised accordingly should these assumptions not hold. At present the count is simply two on the upside (households go back to behaviours of old and wage setting behaviour follows the boost in the CPI) and one to the downside. It is hard to see what information the RBNZ is going to receive on these two in the near-term, and we view them as more of a late 2010 and 2011 issues. **So the downside stemming from sovereign debt concerns seems the more prevalent near-term risk.** Accordingly there will remain some uncertainty over the pace of the removal of policy stimulus over 2010. We remain very cautious towards global developments.

In this regard, **the RBNZ's projections for overall trading partner growth were revised up relative to the March Statement** (4.2 percent in 2010 from 3.6 percent, and 4.0 percent in 2011 from 3.9 percent). Trading partner growth remains strong in 2012 at 4.3 percent. Much of the upward revision is attributable to stronger growth in Australia and Asia (including-Japan). Projections for the Euro area and the UK were only shaded down marginally, and are a source of clear downside risk going forward, in our view. Given recent developments in Europe and risks of contagion elsewhere, there is a clear risk that the global outlook will be appreciably weaker. The RBNZ are keenly aware of this with a key assumption behind their forecasts being that trading partner growth is not impacted by offshore sovereign risk concerns in Europe.

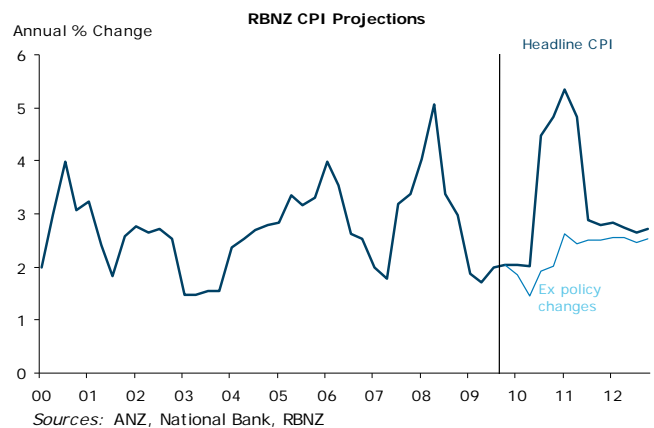
Projections for household consumption spending are noticeably weaker than the March MPS projections. A key assumption of the RBNZ is that households continue to consolidate balance sheets (deleveraging). The RBNZ are unsure whether the process of balance sheet repair is ongoing and structural in nature, or is due to run its course. It is assumed that households are taking advantage of low floating mortgage interest rates to reduce debt. With the RBNZ assuming that commodity export prices will eventually weaken, producers will use the current windfall to reduce debt. As the RBNZ are keenly aware there is a risk that this deleveraging does not continue, with implications for the monetary policy outlook.

Countering subdued consumption are stronger export growth and a pickup in investment.

The latter is off lows but gives some modest cyclicity to the forecasts. Relative to ourselves the RBNZ has more growth in 2010 and less in 2011, but the spirit is one of reasonable growth

over the next two years (subject to global developments), which we concur with.

Underlying CPI inflation (excluding policy effects) is forecast to remain within the target band. Rightly, the RBNZ is looking through the spike in headline inflation, which is forecast to peak at 5.3 percent in the June 2011 quarter. Excluding policy changes, underlying inflation is forecast to peak at 2.6 percent. The Bank is focused on ensuring that second round impacts from high headline inflation are contained, and do not seep into wage and price-setting behaviours. With the labour market improving, the RBNZ will be conscious that wage inflation will start to pick up off current low levels.

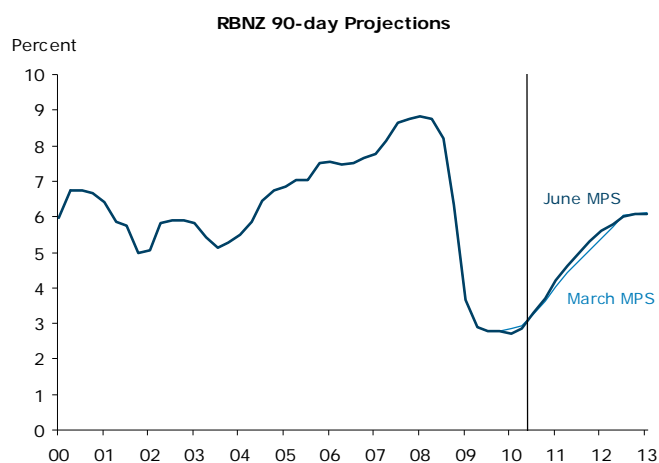


In regards to the outlook for inflation, we continue to ponder the supply-side capacity of the economy. The RBNZ's projections now have trend or potential growth residing at around 2 percent. We agree with this as structural changes stemming from payback from the excess consumption model of the past decades and weak business investment all act to curtail how fast the economy can run without hitting capacity constraints.

The 90-day projection is broadly similar to the March Statement. It is around 20-30bps higher over 2011 but we do not read this as a more aggressive profile. It certainly does not point to 25bp hikes at every single meeting. **We still see three further 25bp hikes taking the OCR to 3.5 percent by October, followed by a pause to assess things.** Beyond that we see the cash rate heading to 5 percent, a number we consider somewhere near neutral. History would suggest a push beyond this but given the structural flow-on from the global financial crisis, this seems a prudent endgame at this stage. Rates are indeed likely to push through neutral at some stage but we think that sort of endgame is well beyond the next couple

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of years, which will continue to be dominated by the lingering after-effects of the global financial crisis. To think that policy would move to a restrictive stance just seems a stretch with history showing that major events tend to linger across economic developments and markets for years.



Sources: ANZ, National Bank, RBNZ

FINANCIAL MARKET IMPLICATIONS

The rate hike cycle has started. Given that the market only had around 20 points priced in for today, the mild selloff in rates was not surprising although the tenor of the RBNZ's assessment relative to the likes of the Bank of Canada was notably more upbeat. Going forward, the focus for the market will be the pace of policy stimulus removal and the ultimate endgame. In this regard, we still envisage a cautious approach by the RBNZ, which does not imply a move at every single meeting which is what the market has priced in. Moving beyond that, we expect offshore developments to again play a key role, and ongoing volatility is to be expected. Fundamentally we remain less sanguine about the global scene than the RBNZ, hence our more cautious view on how quickly the OCR will move up.

RBNZ JUNE 2010 MPS PROJECTIONS (MARCH 2010 MPS IN BRACKETS)						
	GDP (QoQ)	GDP (YoY)	CPI (QoQ)	CPI (YoY)	90-day	TWI
Q1 2010	0.8 (0.9)	2.0 (1.9)	0.4	2.0	2.7	65.3
Q2	1.1 (1.1)	3.0 (2.8)	0.5 (0.5)	2.0 (1.9)	2.9 (2.9)	66.0 (64.4)
Q3	0.9 (1.1)	3.6 (3.8)	1.3 (0.9)	2.0 (1.5)	3.3 (3.3)	65.6 (64.2)
Q4	0.9 (1.0)	3.7 (4.2)	2.2 (0.4)	4.5 (2.0)	3.7 (3.6)	65.4 (64.1)
Q1 2011	0.9 (1.1)	3.8 (4.4)	0.7 (0.5)	4.8 (2.3)	4.2 (4.0)	64.9 (63.7)
Q2	1.0 (0.9)	3.7 (4.2)	1.0 (0.9)	5.3 (2.6)	4.6 (4.4)	64.4 (63.1)
Q3	1.1 (1.2)	3.9 (4.3)	0.8 (0.8)	4.8 (2.6)	5.0 (4.7)	63.8 (62.5)
Q4	0.6 (0.7)	3.6 (4.0)	0.3 (0.5)	2.9 (2.8)	5.3 (5.0)	63.3 (61.9)
Q1 2012	0.2 (0.3)	2.9 (3.1)	0.6 (0.5)	2.8 (2.8)	5.6 (5.4)	62.9 (61.4)
Q2	0.6 (0.6)	2.5 (2.8)	1.1 (0.9)	2.8 (2.7)	5.8 (5.7)	62.3 (60.7)
Q3	0.5 (0.6)	1.9 (2.2)	0.7 (0.8)	2.7 (2.7)	6.0 (6.0)	62.0 (60.2)
Q4	0.4 (0.6)	1.7 (2.1)	0.2 (0.5)	2.6 (2.7)	6.1 (6.1)	61.7 (59.9)
Q1 2013	0.3 (0.5)	1.8 (2.3)	0.7 (0.5)	2.7 (2.7)	6.1 (6.1)	61.2 (59.3)

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FULL TEXT OF THE OCR ASSESSMENT

The Reserve Bank today increased the Official Cash Rate (OCR) by 25 basis points to 2.75 percent.

The economy has entered its second year of recovery with growth becoming more broad-based.

The recovery in trading partner activity is continuing, with growth in Asia particularly strong. Along with ongoing growth in Australia and recovery in the United States, this has so far offset weak growth in some other export markets. Against this backdrop, New Zealand's export commodity prices have increased sharply over the past few months, boosting export incomes.

In contrast to signs of global economic recovery there has been renewed turmoil in financial markets. Currently, we expect the main impact on New Zealand to come through continuing upward pressure on the cost of funds to the banking system.

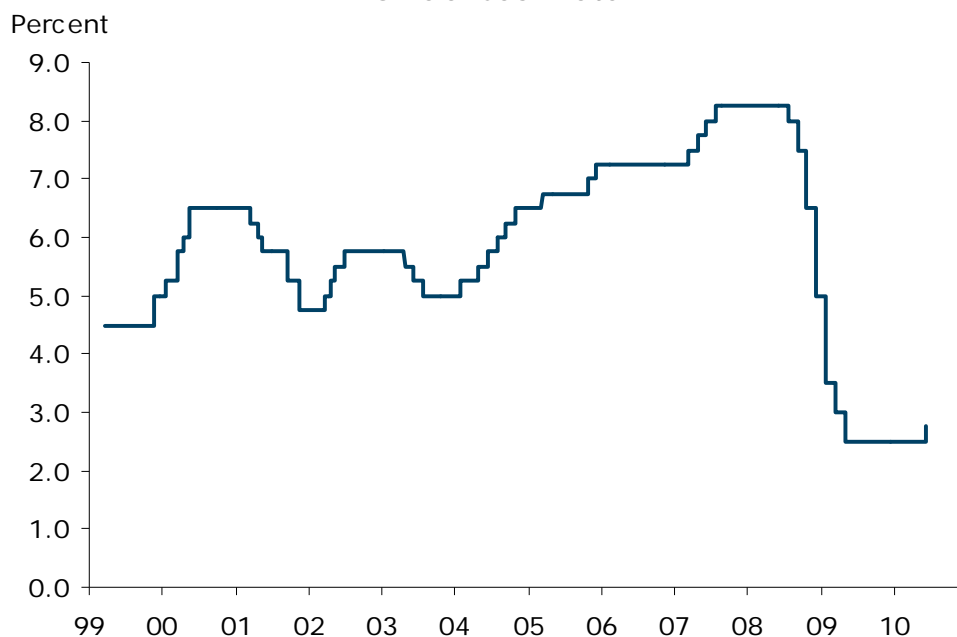
In New Zealand, growth of around 3½ percent is expected this year and next. The main drivers of this outlook are higher export prices and volume growth, an improving labour market and a pick-up in residential and business investment. However, we expect households to remain relatively cautious, with the housing market and credit growth staying subdued. This moderate household spending contributes to some rebalancing in the economy.

Underlying CPI inflation is expected to track within the target range even as the economy expands further. That said, headline CPI inflation will be boosted temporarily by the announced increase in GST and other government-related price changes. Provided households and firms do not reflect this price spike in their wage and price-setting behaviours we do not expect a lasting impact on inflation.

Given this outlook and as previously signalled, we have decided to begin removing some of the monetary policy stimulus that is currently in place. The further removal of stimulus will be reviewed in light of economic and financial market developments.

The fact that bank funding costs are higher, long-term interest rates are higher than short-term interest rates, and a greater proportion of borrowers use floating rate mortgages should all reduce the extent to which the OCR will need to be increased relative to previous cycles.

Official Cash Rate



Sources: ANZ, National Bank, RBNZ

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- Placed in statutory management or receivership.

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