
RESERVE BANK OFFICIAL CASH RATE REVIEW

Key points

- The Reserve Bank raised the OCR by 25bps today to 8.25 percent, in line with our expectations.
- Today's increase was in response to ongoing tight resource pressures, ongoing increases in dairy prices, and sustained inflationary pressures from rising oil and food prices.
- The tenor of the statement was less hawkish than the market was expecting, with the Reserve Bank moving into neutral mode, noting that they believed the four successive interest rate hikes delivered so far this year will be sufficient to contain inflation.
- With the NZD at historical highs and fixed mortgage rates now testing 9 percent, monetary policy looks to have evolved from the scientific approach towards a more judgemental one – an inevitable change that needs to occur at the end of cycles.
- We expect the OCR to remain at 8.25 percent for an extended period.

Assessment

Today's OCR increase was in response to ongoing tight resource pressures in the economy and rising dairy prices. In essence, the Reserve Bank was being consistent with what they had signalled in their June *Monetary Policy Statement*, where the upside scenario they presented incorporated a further interest rate increase. There was much discussion in the lead up to today's decision about whether the currency would have any bearing. In the end, the Reserve Bank acknowledged that the currency is hurting exporters and repeated their message that the New Zealand dollar is not sustainable. By increasing rates in response to inflationary pressures, the Reserve Bank has shown a willingness to look through the current level of the exchange rate and focus on ensuring that inflation is contained.

The interest rate increase can also be seen as a pre-emptive move in response to structural changes in commodity prices. The prospect of higher oil and food prices in sustaining inflationary pressures is also one of the factors behind today's move. Certainly, we are in the midst of a structural shift in commodity prices, in which New Zealand stands to benefit. However, the rise in commodity prices does pose challenges for monetary policy, as the Governor noted in a recent speech¹. With food prices starting to rise and a real possibility of higher petrol prices when the New Zealand dollar eventually corrects, the Reserve Bank is looking to quickly contain inflation now to provide room to absorb the impact of structurally higher commodity prices.

The Reserve Bank has now shifted into neutral mode. While domestic inflation remains elevated and sticky, the dairy sector is still set for a further income boost, and fiscal policy will continue to be expansionary; the Reserve Bank is putting weight on anecdotes that the housing market and borrowing is starting to moderate. Though the data to date is still inconclusive, as a bank, we can attest to this when we look at our own books. The key phrase is "*we think the four successive OCR increases we have delivered will be sufficient to contain inflation.*" The Reserve Bank's move to neutral is reminiscent of January 2006, when they signalled that they did not expect to raise rates further. **But there is still an 'out clause'**. The Reserve Bank's neutral stance is on the proviso that the moderation in household borrowing continues, and pressure on resources continue to ease.

We are at a juncture where the science to monetary policy is being balanced by judgment. Applying the strict "science" to monetary policy, based on the data at hand, would point towards keeping a firm tightening bias. But monetary policy takes time to have an effect, and the data comes with a lag. There is no doubting that the currency at current levels is exerting some real pain across some pockets of the export sector, and fixed rate mortgages above 9 percent will start to bite on household budgets. Certainly, the various forward indicators we monitor are pointing towards a slowdown over the second half of this year. Judgement suggests a neutral bias is appropriate.

The challenge for the Reserve Bank is to ensure that financial conditions remain restrictive enough to ensure further signs of the moderation they require. Financial markets reacted to the dovish statement by sending the New Zealand dollar down 35pips against the USD and the 2-year swap yield down 5bps. Despite today's OCR increase, financial conditions have actually eased. Over the coming months, the

¹ "*Commodities, dairy prices and the New Zealand economy*", a speech by the Reserve Bank Governor to the Waikato Grasshoppers, 12 June 2007.

challenge for the Reserve Bank is to keep the yield curve up and prevent the market from pricing in easings prematurely, to ensure that financial conditions are still restrictive enough to ease domestic demand. Certainly, the Reserve Bank will be mindful of the early 2006 experience. In contrast to early 2006, the upcoming dataflow is not expected to collapse so markedly. Importantly, this should see the Reserve Bank maintain policy traction along the yield curve – fostering an eventual moderation in growth.

Reading between the lines, the shift to a neutral bias could also reflect the prospect that something is happening behind the scenes, in the form of additional support to monetary policy from other policy areas, that is not publicly available yet.

The real message today is one of stability. We believe today's increase is finally the last one for this tightening cycle. However, any prospects of easings are still a long way off. We continue to pencil in the start of the easing cycle in late 2008. Ultimately, the Reserve Bank needs concrete signs that inflation is easing before they can contemplate cutting the OCR. As noted above, with structurally higher commodity prices placing upward pressure on prices, it may take some time for headline inflation to return comfortably to the middle of the target band. We continue to expect the currency to be the main release valve that any weakness in the economy is expressed through.

From a markets perspective, the bias will be to trade the ranges in rates. The dataflow is still expected to print on the strong side for a short while yet (particularly the Q2 wages and employment reports), which the market will jump on. For the currency, New Zealand's high yields will continue to provide support. But ultimately, it is interest rate expectations and economic growth that matter. With the tightening cycle now over and the next move in rates more likely to be down, the NZD should struggle to extend materially.

Text of OCR Review below

The Official Cash Rate (OCR) will increase by 25 basis points to 8.25 percent.

Reserve Bank Governor Alan Bollard said: "The New Zealand economy is running strong. We are recording continued big increases in international commodity prices, especially dairy, reflecting solid world demand for our products.

"This is very good news for New Zealand. Given this positive situation, some of the negative commentary circulating about the economy is unwarranted.

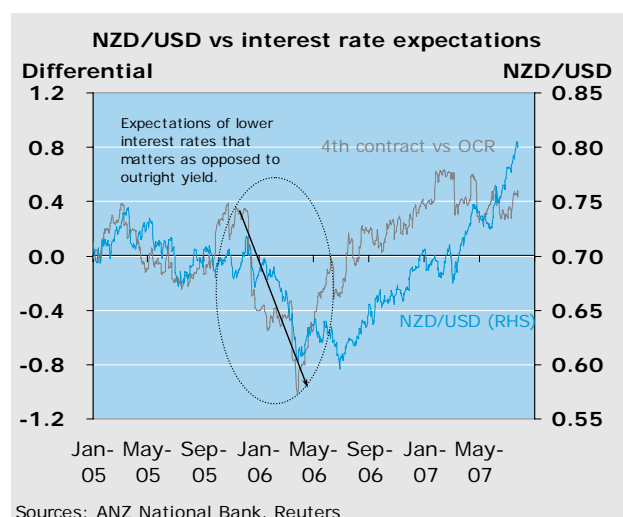
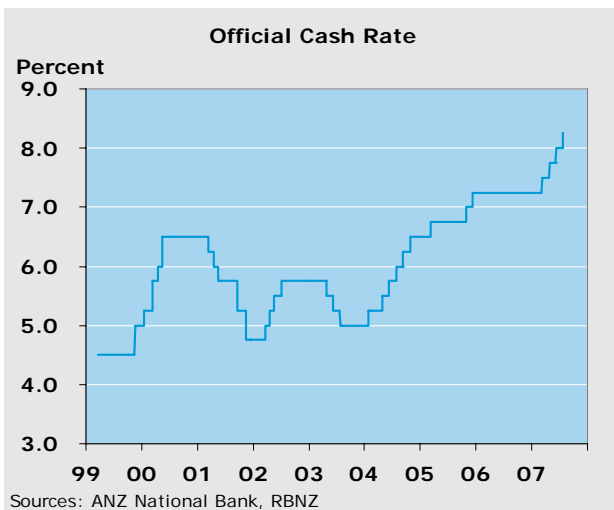
"However, the continued tight labour market, high capacity use, and rising oil and food prices all point to sustained inflationary pressures. That is why we are increasing the OCR today.

"The New Zealand dollar has reached very high levels recently, driven by US dollar weakness and New Zealanders' heavy demand for borrowing. This level of the currency has been hurting exports.

"The high New Zealand dollar is not sustainable medium term and investors should understand this. The higher OCR now gives strong incentives to New Zealanders to save.

"New Zealanders have been showing early signs of moderating their borrowing.

Provided they keep this up, and the pressure on resources continues to ease, we think the four successive OCR increases we have delivered will be sufficient to contain inflation."



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