Economic Review
New Zealand
24 April 2008

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RBNZ Official Cash Rate Review

Key points

> **The OCR was left unchanged at 8.25 percent as widely expected.**

> **Weakening economic activity acknowledged, though inflation concerns remain for the RBNZ.**

> **The statement attempts to balance the downside growth risks with upside inflation risks but the former has a greater risk profile, being viewed as *"significant"*.**

> **Key phrase change: The RBNZ expects the OCR to remain at current levels for *"a time yet"*, a step down from the March statement which noted rates at current levels *"for a significant time yet"*.**

> **We continue to expect rates to move lower in 2008.**

Assessment

A no change was always a given at today's OCR *Review*. The current inflation rate and the ugly near-term inflation outlook due to higher food and energy prices ties the RBNZ's hand. **The main focus was on the tone of the statement, and in this regard a slightly softer one came through.**

Still some strong growth pillars, but for how long? *"Economic activity has weakened more markedly"* compared to their March projections, a prudent acknowledgement of the rapid change in the economic outlook. However, the Bank still sees a strong labour market, high commodity prices and fiscal expansion as limiting the economic slowdown. We note however, that the RBNZ has had a material rethink on global growth. In the Governor's speech earlier this month, he noted that world growth did not look unusually weak. In contrast, today's statement referred to weaker prospects for world growth. In addition, the RBNZ acknowledged tighter credit conditions for the first time. These could yet have more of an impact on the Bank's view on NZ growth prospects (when they do a full update of their projections for the June *Monetary Policy Statement*).

Higher food and petrol prices look set to push headline inflation higher this year. But they also act as an indirect deflationary force by reducing household disposable incomes and curbing domestic demand. In many ways, the effect of higher food and petrol prices is similar to higher interest rates. The only difference being that interest charges are not included in the CPI calculation. So while the near-term inflation impact from higher food and petrol prices is strong, the deflationary effects from dampened domestic demand will start to filter through. But this hinges on those price effects not being fully compensated for by wage increases.

Housing won. Labour market next and wage bargaining behaviour needs to be contained. Comments today about wage settlements responding to short-term price shocks rather than changing economic conditions appear designed to cap upcoming wage bargaining expectations so as not to further put upward pressure on inflation. This has been a recurring theme in recent speeches by the Governor. It is clear that, having won the battle over housing, the labour market (and wages) is now the main battlefront to contain inflation. In this regard, labour market indicators are the key to watch going forward.

The RBNZ continues to see the OCR at current levels for *"a time yet"*, but this is a step down from the March statement where they saw rates on hold *"for a significant time yet"*. Apart from being an appropriate response to an altered outlook (and we suspect partly aimed at the currency), we have three reads on this.

- The RBNZ is more fully aware of the additional tightening in financial conditions pending from the credit channel, which risks taking monetary conditions too far.
- We now see the RBNZ pulling forward the timing of the easing profile in their June *Statement*, relative to that expressed in March, with the latter indicating rates on hold until H2 2009.
- The statement gives the RBNZ the flexibility to respond should the outlook deteriorate markedly, as seems a non-trivial risk at present.

We remain comfortable calling a second half of year easing beginning in September. Prospects for lower rates, however, remain contingent on labour market developments, which we expect to turn rapidly given the altered real economic environment.

The market latched on to the softer tone in today's statement, sending the NZD/USD down 50pips and swaps rallying by 6-11bps. At the moment, the currency looks set to be the main release valve that weakness in the economy is translated through. But the RBNZ is unlikely to be too perturbed by the rally in swaps, as the current credit environment will not see this pass through into lower retail mortgage rates. Given increasing signs that the policy outlook between NZ and Australia could diverge this year (with risks to rates to the upside in Australia following yesterday's strong Q1 CPI print), the NZD/AUD is expected to remain under further downward pressure.

Text of OCR review below:

The Official Cash Rate (OCR) will remain unchanged at 8.25 percent.

Reserve Bank Governor Alan Bollard said: "Economic activity has weakened more markedly than expected in the Bank's March *Monetary Policy Statement*. There have been sharp falls in consumer and business sentiment, exacerbated by tighter credit conditions, a further decline in the housing market and weaker prospects for world growth. Financial market turbulence around the world continues to add to an uncertain economic environment. Further, the very dry summer is also weakening short-term growth prospects.

However, the labour market is still strong and New Zealand's key international commodity prices remain high. Government spending plans and the possibility of personal tax cuts can also be expected to limit the economic slowdown.

The weaker economy will, over time, ease accumulated pressure on resources and reduce inflation pressure. However, short term inflation is likely to remain persistently high, due in large part to repeated increases in food and energy prices. There is a risk that wage settlements respond to these short term price shocks rather than adjusting to the changing economic conditions, thus perpetuating inflation pressures.

We see significant downside risk to future activity but upside risks to inflation. A further risk to the outlook is the persistently strong New Zealand dollar which, while helping moderate headline CPI inflation, remains a drag on export growth.

Given this outlook, we expect that the OCR will need to remain at current levels for a time yet to ensure inflation outcomes of 1 to 3 percent on average over the medium term.

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