

NEW ZEALAND ECONOMICS

RBNZ DECEMBER *MPS* REVIEW

8 December 2011

CONTRIBUTORS

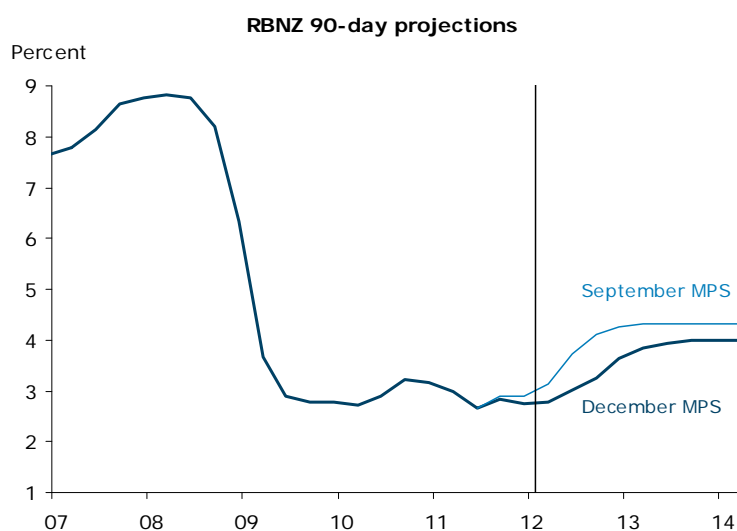
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GOING NOWHERE FAST

KEY POINTS

- The RBNZ left the OCR unchanged at 2.5 percent. The Bank noted that “Given the current unusual degree of uncertainty around global conditions and the moderate pace of domestic demand, it remains prudent for now to keep the OCR on hold at 2.5 percent.” This is similar to what they said in October. However, the tightening bias from the October review has been dropped.
- The RBNZ’s 90-day interest rate projection was revised down considerably, with a later and less steep increase, peaking at 4.0 percent compared to 4.3 percent in the September MPS.
- Unsurprisingly, the global picture was revised down substantially with a prolonged recession assumed in Europe.
- Funding costs are assumed to stay high with average costs increasing further, but this is already taken into account in the forecast interest rate track.
- Tellingly, the RBNZ produced an alternative scenario which was reverse engineered to match market pricing of two weeks ago (a flat 90-day interest rate profile). This entailed a global recession two-thirds as weak as 2008 but with a bounce-back half as fast. This suggests the hurdles for a rate cut are considerable, despite the shift to a more neutral bias today.
- Our view remains unchanged: the RBNZ is on hold for quite a while.



Sources: ANZ, National Bank, RBNZ

DATA REVIEW

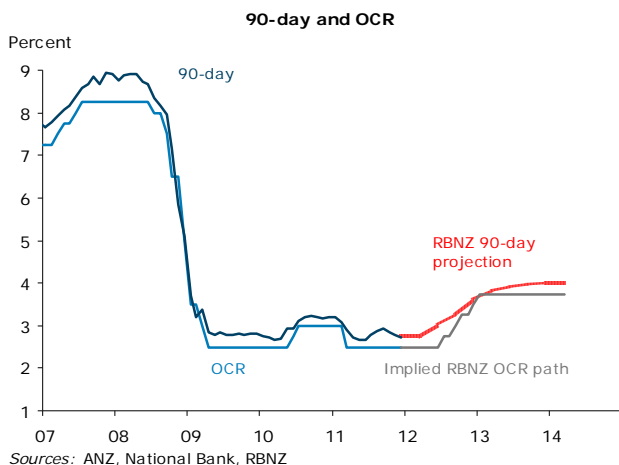
COMMENT AND ASSESSMENT

The decision to leave the OCR unchanged was a given, with the main interest in today's *Monetary Policy Statement (MPS)* being the rhetoric and change to the macroeconomic forecasts. Compared to the September MPS (and the October OCR Review), the tone was more downbeat, with a more negative outlook for the global economy and higher assumed bank funding costs. This was not surprising given that the global economic outlook had deteriorated since the RBNZ's last set of forecasts, and European sovereign debt concerns are still unresolved.

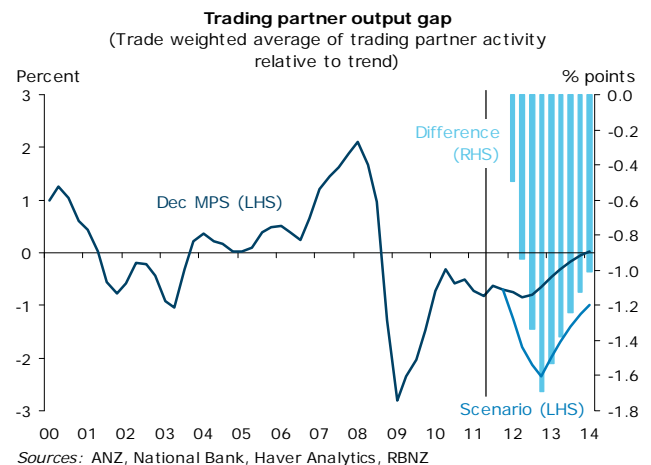
In explaining its decision to leave the OCR on hold at 2.5 percent, the RBNZ cited "the current unusual degree of uncertainty around global conditions and the moderate pace of domestic demand." This is very similar in spirit to their October Review. However, the RBNZ made no reference to the OCR moving up this time, a clear change from prior communication.

This means that the RBNZ has now shifted into neutral gear. However, this does not mean that the Bank is signalling any intention to ease. Far from it. True, the RBNZ's 90-day projection has been revised down considerably, with a later and less steep increase, peaking at 4.0 percent compared to 4.3 percent in the September MPS. But it still shows the 90-day interest rate moving up, eventually.

Technically, the RBNZ's 90-day interest rate projections look to have the OCR moving up from around the middle of 2012. However, this looks nothing more than the passive workings of their economic model, and is based on a pretty benign central view of global developments. **Sifting the tea leaves, the spirit of the RBNZ's view is simple: the odds are that the next movement is up, but not for a very long time.**



To get an idea of the hurdle that needs to be cleared before the RBNZ cuts the OCR, the alternative scenario presented in the MPS is quite telling. This is the first time that the RBNZ has produced an alternative scenario (featuring a weaker outlook for global activity) for some time – a clear indication of the uncertain outlook, and where the balance of risks lie (i.e. all to the downside). RBNZ staff commented that the scenario had been reverse engineered to match market pricing of two weeks ago, at which time the implied 90-day track was completely flat. The scenario thus investigated the question, "How weak would global growth have to be to have interest rates flat indefinitely?" The answer: a trading-partner recession two thirds as deep as 2008 in output gap terms, but which bounces back only half as fast, given that fiscal and monetary policy bullets are now largely spent. In terms of the size of the cumulative negative output gap, this is in fact a considerably weaker global scenario than the 2008 recession.



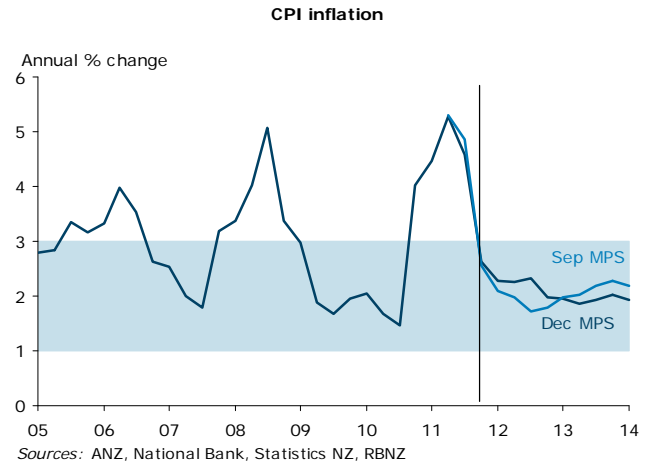
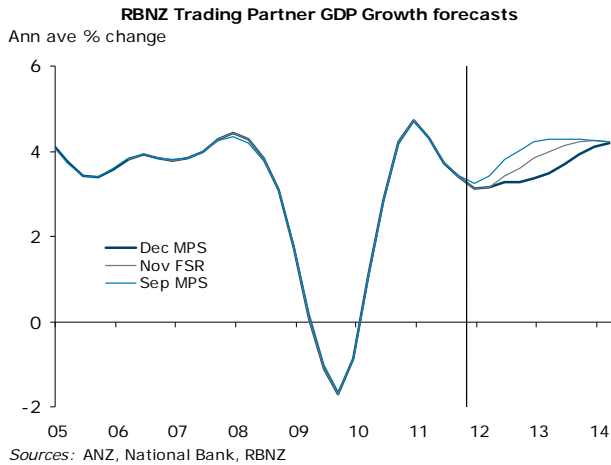
This implies that the hurdle for OCR cuts is high. However, an "alternative" alternative scenario of a much sharper rise in funding costs than assumed would have also made very interesting reading. If this were to pan out, then a less dramatic global slowdown might suffice. But the main message is clear: **in the RBNZ's view, markets got well ahead of themselves when they started pricing in cuts** (which were subsequently priced out, prior to today's MPS).

Looking at the assumptions underpinning the RBNZ's central projection, forecasts for global growth were revised down considerably. Europe is now forecast to go into a "prolonged recession", which is assumed to have already begun. This has flow-on effects on global growth more generally, with "slow growth" in the US, and a "modest" downturn in Asia. However, Australian growth is expected to hold

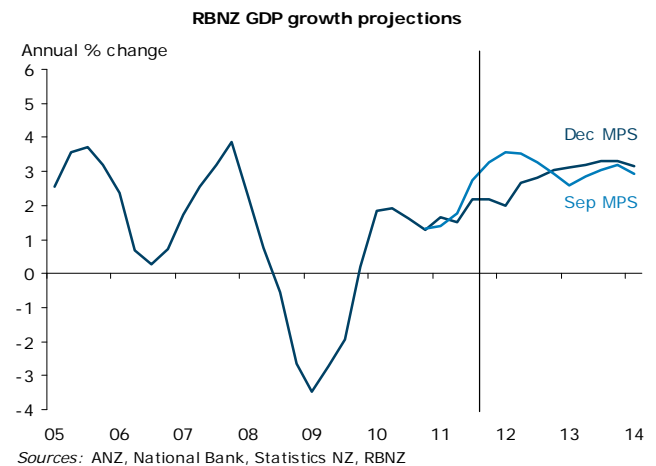
DATA REVIEW

up, with mining investment not derailed by the current turmoil.

nothing the RBNZ can do about the global situation but watch, worry and wait.



Bank funding costs are assumed to hold up and flow into retail rates, and monetary policy “will need to take account of such pressures”. This is already built into the published interest rate track, and higher retail mortgage rates are cited as a dampening impact on consumption going forward, as average bank funding costs rise. To date, this has not occurred, and the fall in wholesale interest rates over the past two months has actually seen fixed mortgage rates decline across the curve. **The fact that the RBNZ has explicitly incorporated a rise in funding cost again reinforces our view that the hurdle to rate cuts is high.**



The other main highlights of the Bank’s forecasts were as follows:

- Inflation is not an issue. Underlying inflation is projected to stay comfortably in the middle of the target band, and the RBNZ notes that wage and price setting pressures have remained contained.
- Assumptions regarding the Canterbury rebuild were unchanged (and remain a source of downside risk, i.e. a potential delay).
- Lower business confidence is assumed to dampen business investment.
- GDP growth is lower, mostly due to the starting point surprise.
- The terms of trade forecast and the TWI assumption were revised down.

All-up, today’s MPS was consistent with our view that the OCR is on hold for an extended period. We have pencilled in December 2012 for the start of policy normalisation, but the spirit is what matters: rates are on hold for a long time. There is

RBNZ DECEMBER 2011 MPS PROJECTIONS (SEPTEMBER 2011 MPS IN BRACKETS)				
	90-DAY	TWI (QTR AVERAGE)	CPI (ANN % CHG)	GDP (ANN % CHG)
Q1 2011	3.0	67.1	4.5	1.7
Q2	2.7	69.1	5.3	1.5
Q3	2.8	72.5	4.6 (4.9)	2.2 (2.7)
Q4	2.7 (2.9)	68.0 (72.4)	2.6 (2.6)	2.2 (3.3)
Q1 2012	2.8 (3.1)	67.0 (72.4)	2.3 (2.1)	2.0 (3.6)
Q2	3.0 (3.7)	66.7 (72.1)	2.2 (2.0)	2.7 (3.5)
Q3	3.3 (4.1)	66.4 (71.7)	2.3 (1.7)	2.8 (3.3)
Q4	3.6 (4.3)	66.3 (71.1)	2.0 (1.8)	3.0 (2.9)
Q1 2013	3.8 (4.3)	66.0 (70.6)	2.0 (2.0)	3.1 (2.6)
Q2	3.9 (4.3)	65.9 (70.2)	1.9 (2.0)	3.2 (2.8)
Q3	4.0 (4.3)	65.7 (69.8)	1.9 (2.2)	3.3 (3.1)
Q4	4.0 (4.3)	65.6 (69.4)	2.0 (2.3)	3.3 (3.2)
Q1 2014	4.0 (4.3)	65.5 (69.0)	1.9 (2.2)	3.2 (2.9)

DECEMBER MONETARY POLICY STATEMENT POLICY ASSESSMENT

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.

Reserve Bank Governor Alan Bollard said: "As foreshadowed in the September Statement, global conditions have deteriorated. Continuing difficulties related to sovereign and bank debt in a growing number of European economies have resulted in high levels of volatility in financial markets. There has also been a softening in international economic activity, including in the Asia-Pacific region.

"Global developments are having some negative impact on New Zealand, though to date it has been limited. Business confidence has declined and investment spending is likely to remain weak for some time. In addition, tightness in international markets means funding costs for New Zealand banks will increase to some degree over the coming year.

"There remains a high degree of uncertainty around the global outlook and, as discussed in the scenario in this Statement, there is a risk that conditions weaken further.

"Domestically, economic activity continues to expand, though at a modest pace. Although off their peaks, export commodity prices remain elevated. In addition, the depreciation of the New Zealand dollar provides some support for the tradable sector of the economy. Over time, repairs and reconstruction in Canterbury will also provide a significant boost to demand for an extended period.

"Annual headline inflation is estimated to have returned within the Bank's 1 to 3 percent target band in the December quarter. Underlying inflation continues to sit close to 2 percent. In addition, wage and price setting pressures have remained contained.

"Given the current unusual degree of uncertainty around global conditions and the moderate pace of domestic demand, it remains prudent for now to keep the OCR on hold at 2.5 percent."

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