

# NEW ZEALAND ECONOMICS

## RBNZ OCR REVIEW

29 April 2010

### CONTRIBUTORS

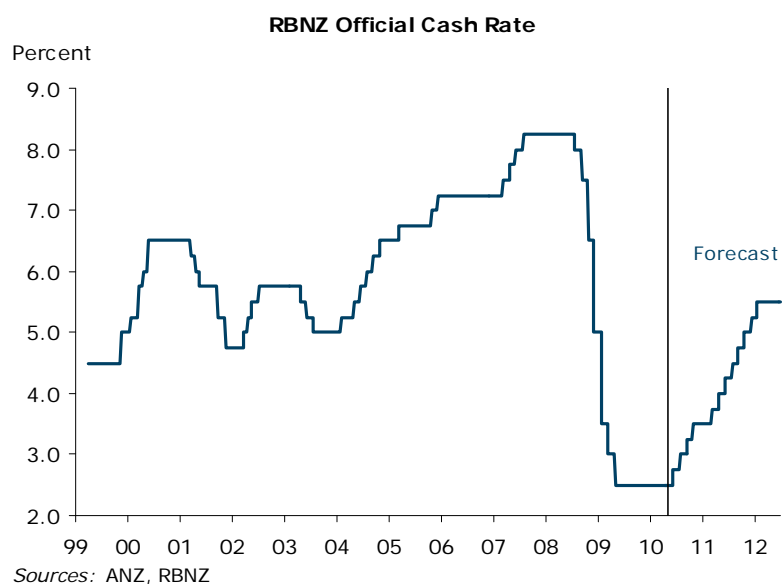
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## RBNZ GIVING ITSELF FLEXIBILITY

### KEY POINTS

- The RBNZ left the OCR unchanged at 2.5 percent. In regard to guidance on when rates will move up, the “middle of 2010” phrase was removed, as we had expected, and replaced with “over the coming months”.
- The exact timing remains conditional on the economy evolving and continuing to pick-up as the RBNZ had projected.
- We take “the coming months” to mean literally that, which means a toss-up between June and July. Absent a material contagion effect from offshore sovereign debt concerns, September feels too far away.
- We prefer June for the first hike.
- The RBNZ noted that the extent of OCR increases will be less compared to previous cycles due to the wedge between the OCR and lending rates, and the steep yield curve.
- So beyond semantics over the timing of the first hike, the underlying message is that rates should not move up as far.
- We have pencilled in four hikes, taking the cash rate to 3.5 percent by October, before pausing to assess the water. Moving early allows more scope for patience.

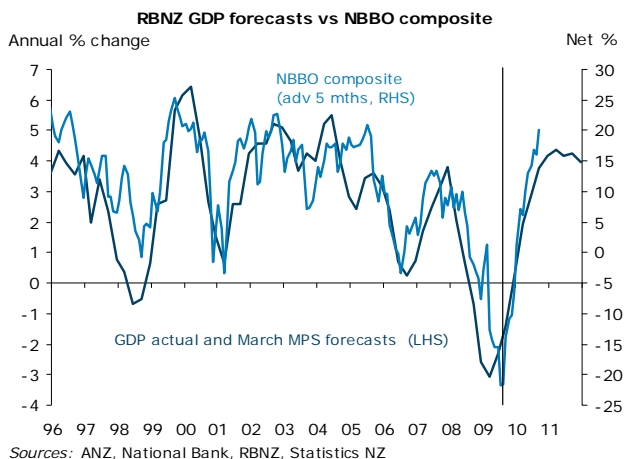


# RBNZ OCR REVIEW

## COMMENT AND ASSESSMENT

**There was never any doubt about a no change decision.** The focus was always going to be on the tone of the policy assessment, and whether the "middle of 2010" phrase was going to be removed. **As we had expected, the RBNZ replaced the mid-year phrase with "over the coming months"**, which effectively gives them wiggle room in terms of when to begin the tightening cycle.

**We take "the coming months" as a toss up between June and July.** September simply feels too late despite the attachment of some conditionality ("provided the economy continues to evolve as projected") and the fact that the near-term data outturns suggest that growth over the first half of this year is unlikely to match the RBNZ's 1 percent per quarter expectations. However, this must now be balanced against some positive H2 2010 and 2011 growth dynamics such as strong global dairy prices that, if maintained around US\$4,000/tonne (and if sovereign tensions in Europe stop the NZD/USD moving up too far) imply the dairy payout may have a 7 in front of it for next season. This, alongside strengthening business confidence, suggests that the RBNZ has downplayed somewhat the recent softness in the domestic data. We concur with this, and believe prospects for 2011 are starting to look very robust.



**In terms of June versus July, we are now more inclined towards the former, and are formally changing our call from September to June.** There is nothing magical about this apart from the fact that we believe turning points in the monetary policy cycle should have the benefit of a full Monetary Policy Statement, which allow the "plan" to be better conveyed. Of course this could be done in July as well so we are really talking

semantics here. After all, the easing cycle in 2008 did start on a Review date. **NZ data is notoriously volatile and prone to "switching on and off. We are detecting that the switch is about to be flicked on.** This is based on recent anecdotes we have been picking up in our travels around the country, and the strength in recent business confidence data. **If we are correct, we believe there will be enough evidence by the June Statement for the RBNZ to begin removing policy stimulus.** Of course, this will not all be one-way traffic. We fully expect some dynamics such as business investment to remain subdued for a while yet, and for deleveraging to still be a key feature across the economy. We find the former somewhat problematic in terms of what it implies for the supply-side capacity of the economy – and the impact on inflation.

**Beyond June we are inclined to pencil in 3 more hikes which takes the OCR to 3.5 percent by October, and then a pause to assess the water, before heading towards the endgame at around 5.5 percent.** As the RBNZ notes, "The increased wedge between the OCR and lending rates, as well as a steeply positive-sloped interest rate curve, is expected to make OCR increases more effective than in the past. Accordingly, these factors should reduce the extent to which the OCR will need to be increased relative to previous cycles."

We are also mindful of the potential for the odd global setback, and also the considerable structural changes that will impact the economy over the coming year (i.e. the tax system which is likely from October 1). In addition, the data is likely to be very noisy. **In that set of circumstances, and given the slope of the yield curve, going early (June) would appear to give the RBNZ more flexibility to be gradual over the pace of tightening.** Or put it another way, it is difficult to see 8 or more successive 25bps hikes in the OCR immediately given the current state of the housing market. If there is an upside risk to this view at present (and where we would see the neutral interest rate), it stems from pending terms of trade gains. However, further extensions in NZ's commodity prices from this point require the China growth story to kick-on further. Given inflationary pressures there and steps by Chinese policymakers to cool their economy, this will be a challenge.

**In terms of the overall policy assessment, it was short and balanced.** Upside surprises were

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noted, particularly the recovery in NZ's trading partner growth and high export commodity prices. Specifically, the RBNZ sees some upside risk to NZ economic growth compared to their March projections. But the RBNZ still noted risks to the global outlook, which they describe as "elevated". The Bank's view on the domestic economy was more guarded, noting cautiousness amongst households, subdued housing market and credit growth, and weak business spending. Despite some obvious one-offs that is set to send headline inflation past 5 percent this year (tobacco tax increases, emissions trading scheme charges, possible GST increase), the RBNZ has not expressed any concern over inflation, expecting it to track within the target range over the medium term. This suggests the RBNZ is focused on underlying inflation and will only focus on potential second round impacts, as they should.

**Interestingly, no mention was made of fiscal policy this time.** While government policy, such as the surprise decision to raise tobacco taxes overnight, is set to push headline inflation higher, there is no doubting that fiscal consolidation is underway and that the fiscal stance is moving into contractionary mode. This should assist monetary policy rather than work against it.

### FULL TEXT OF THE POLICY ASSESSMENT

OCR unchanged at 2.5 percent

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

Reserve Bank Governor Alan Bollard said: "The New Zealand economy is recovering broadly as expected and growth is predicted to pick up further through 2010.

"Trading partner activity has recovered more quickly than we expected. Growth in Asia has been particularly strong. Consistent with this, export commodity prices have increased close to their 2008 peak. At the same time, risks to the global outlook remain elevated.

"Notwithstanding the impact of stronger than expected export earnings, New Zealand households remain cautious, with the housing market and household credit growth subdued. Similarly, business spending is weak and firms continue to reduce debt.

"On balance, we continue to expect the New Zealand economy to recover in line with or slightly faster than our March Statement projection. Annual CPI inflation, which has been close to 2 percent for

the past year, is expected to track within the target range over the medium term.

"As previously indicated, we expect to begin removing policy stimulus over the coming months, provided the economy continues to evolve as projected.

"The increased wedge between the OCR and lending rates, as well as a steeply positive-sloped interest rate curve, is expected to make OCR increases more effective than in the past. Accordingly, these factors should reduce the extent to which the OCR will need to be increased relative to previous cycles."

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