
RESERVE BANK OFFICIAL CASH RATE REVIEW

Key points

- The RBNZ left the OCR unchanged at 7.25 percent, as we had expected.
- The tenor of the statement was unequivocally hawkish, with the RBNZ set to hike in March in the absence of clear signs of moderation in the housing market and domestic demand.
- When we eyeball the upcoming calendar, we expect the overall tenor to be (just) insufficient for them to pull the trigger.
- The National Bank *Business Outlook* for February will be a key gauge assessing whether the recent fillip in growth will be sustained into 2007.
- The RBNZ's concern over medium-term inflation pressure has necessitated some changes to our interest rate forecasts. While we do not envisage a hike, we find it difficult to envisage lower rates anytime soon, and the 2008 *Budget* is likely to be a sticking point to any eventual easing cycle - even 18 months out.
- We now expect rates to remain on hold for 2007 and 2008, an exceptionally long interest rate cycle, but a reflection of the view we feel we must take in the current environment.
- We will likewise be reviewing our currency forecasts.

The Review

- The Reserve Bank left the OCR unchanged at 7.25 percent.
- Despite GDP growth coming in weaker than the Bank expected in September, they remain very concerned about the apparent pick up in domestic activity. *"While indicators show that economic growth was continuing to moderate in the third quarter of 2006, it is increasingly apparent that domestic demand has rebounded since then, with retail trade picking up, a resurgent housing market and consumer and business confidence recovering strongly."*
- The Bank is looking through the benign near-term inflation outlook and focusing on the upside risks they see to medium term inflation. *"Annual CPI inflation fell to 2.6 percent in December and is projected to decrease considerably further through 2007, thus helping to lower inflation expectations. But the medium-term outlook is less rosy, with annual rates of inflation projected to return to the upper part of our target range through 2008 and into 2009."*
- If the Bank does not see moderation in the housing market or consumer spending data, they will hike rates in March. *"In the absence of clear indications of a moderation in housing and domestic demand, it is likely that further policy tightening will be required. The situation will be reassessed in the light of a full review of our economic forecasts at the March Monetary Policy Statement."*

Assessment

The Reserve Bank left the OCR unchanged, but the statement was unequivocally hawkish. The weaker than expected Q3 GDP and Q4 CPI outturns clearly weighted heavily on today's decision to hold rates unchanged. But the recent pick-up in business confidence and other indicators have the Bank on the edge, and still worried about the medium-term inflation outlook. But given the mixed nature of the data, and the fact that things have not panned out as they had projected in the December *MPS*, Dr Bollard decided to err on the side of caution and wait.

Today's assessment should be seen as buying time. The Bank's view (as was ours) is that the favourable near-term inflation outlook has given them time to wait for more data and carry out a full assessment at the March *MPS*, before deciding on the next course of action.

The Reserve Bank needs to see signs of easing growth to stave off hiking. Given the clear warning contained in today's statement about the need for the Bank to see indications of moderation in housing and domestic demand to starve off a rate hike, the dataflow from now till the March *MPS* will be crucial, starting with the building consents data at the end of this month, through to labour market, housing and retail sales data in February. We suspect the Reserve Bank will get no joy from the overall tenor of the data.

However, the key in our eyes will be readings on Q1. The Reserve Bank notes that it is becoming more uncertain whether the required slowdown is developing. The flipside to this is that it needs to be certain that growth is truly reaccelerating beyond Q4 2006 in a sustained fashion in order to justify a hike. The National Bank *Business Outlook* will be a key read in this regard. The survey picked the last turning point well, and continued resilience in confidence will merely affirm that momentum is being sustained. Conversely, any turn down will challenge the sustained recovery view. Likewise readings from other Q1 indicators such as credit growth, building consents (January), credit card billings, and the REINZ report for January will be persuasive. These indicators need to soften to avert rates moving up. However the danger from a markets perspective is that the Q4 HLFS (employment) report holds sway. While a lagging indicator, the Reserve Bank now has zero scope to absorb upside surprises, and continued strength in employment will merely accentuate the sustained recovery view.

We continue to expect rates to remain on hold. While the tenor of the data will likely come in robust, we suspect it will continue to print inconclusive as to whether the upturn is indeed going to be sustained. We remain wary over the near-term path for the currency and how Q1 indicators could pan out. Financial conditions are tight. However, we currently ascribe a 45 percent chance to a hike.

We have made some significant alterations to our interest rate forecasts in light of the Reserve Bank's concerns over medium-term inflation. While we are not buying into the story that the economy is on a sustained recovery as recent indicators suggest, and therefore don't see the need for rates to move up, we find it difficult at present to present a case for rates moving lower – even a year out. Financial conditions remain tight, and have tightened further over recent weeks courtesy of a higher currency. At current levels, we find it hard to see economic growth accelerating away to a level that will threaten the medium-term inflation outlook. There are still pipeline interest rate effects to flow through this year which will help curb consumer spending. And the pain that the corporate sector (especially exporters) is feeling will flow through into the labour market this year. But given the prospect of a large fiscal stimulus in 2008, we equally now find it difficult to envisage lower rates anytime soon. The Reserve Bank is clearly uneasy over the potential path for fiscal policy, and it is difficult to envisage policy loosening any time around the 2008 *Budget*. For this reason, we now expect interest rates to remain on hold for all of 2007 and 2008. This is an exceptionally long period for rates to be on hold (and at a contractionary level at that), but is a view we feel we have to take given the current environment.

Our currency forecasts are likewise under review.

Financial Market Reaction

The NZD/USD fell 20 pips immediately following the no change decision, but sharply reversed those losses and rose past 0.70 once the statement was put out. With prospects for a February hike receding after last night's BoE minutes and yesterday's softer than expected Australian Q4 CPI, and a March hike firmly on the cards in New Zealand, the NZD will remain well bid in the near term. The interest rate market bought into the hawkish rhetoric, with the yield curve up slightly across the board, which will help give the Reserve Bank more traction.

Text of OCR Review below

OCR unchanged at 7.25 percent

The Official Cash Rate (OCR) will remain unchanged at 7.25 percent.

While indicators show that economic growth was continuing to moderate in the third quarter of 2006, it is increasingly apparent that domestic demand has rebounded since then, with retail trade picking up, a resurgent housing market and consumer and business confidence recovering strongly. The main drivers appear to be the decline in petrol prices since last October, a pickup in net immigration and an expansionary fiscal policy.

At the same time, headline inflation has reduced as a result of the lower oil prices and the strengthening of the exchange rate in the fourth quarter. Annual CPI inflation fell to 2.6 percent in December and is projected to decrease considerably further through 2007, thus helping to lower inflation expectations. But the medium-term outlook is less rosy, with annual rates of inflation projected to return to the upper part of our target range through 2008 and into 2009.

While the near-term inflation outlook is relatively benign, we remain concerned about the upside risks to medium-term inflation. In particular, our assumption that the housing market and consumer demand will resume their slowing trend over 2007 and 2008 is looking more uncertain, particularly if further fiscal expansion occurs.

In the absence of clear indications of a moderation in housing and domestic demand, it is likely that further policy tightening will be required. The situation will be reassessed in the light of a full review of our economic forecasts at the March Monetary Policy Statement. A return to a moderating trend in housing and domestic demand will be essential if we are to see a reduction in medium-term inflation pressures.

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