
RESERVE BANK OFFICIAL CASH RATE REVIEW

Key Points

- OCR left unchanged at 8.25 percent, with the RBNZ remaining in wait-and-see mode.
- Statement is balanced but with familiar hawkish undertones towards inflation pressure.
- Fiscal policy is strongly on the RBNZ's watch-list.
- While the RBNZ sees the current level of the OCR as consistent with maintaining inflation within their 1-3 percent target band, easings remain a long way off given the one sided nature of inflation risks.

Assessment

The RBNZ left the OCR at 8.25 percent today and delivered a short and reasonably balanced statement. Their view of the world is broadly in line with their central projections from the September *Monetary Policy Statement*.

There is a familiar hawkish undertone towards inflation pressure. The RBNZ views that core inflationary pressures persist. The usual concerns about inflation risks are there: tight labour market, spillover from strong commodity prices and food price inflation. But on the other hand, the housing cycle has turned though we are yet to see this flow through into easing housing-related inflation. In addition, the RBNZ cites considerable uncertainty over global financial markets and the potential downside risk to trading partner growth, as well as the high level of the New Zealand dollar.

There are some strong comments towards fiscal policy. The RBNZ do not view that maintaining strong surpluses by itself as meaning fiscal policy is not adding to inflation pressure, explicitly noting "*Despite ongoing surpluses in the government's operating balance, fiscal policy is contributing to inflationary pressure.*" With the Government expected to reap more tax revenue from the terms of trade surge, any recycling of those additional tax revenues will lean against the RBNZ's efforts. Such an assessment is at odds with Dr Cullen's recent statement as part of the Financial Statements of Government for the year ended June 2007 where he stated "*The net result of these developments (higher tax revenue of \$0.7 billion and department under-spend of \$0.8 billion) is that the Government was removing significantly more demand from the economy than forecast at Budget time – it would be difficult to argue that the Government is contributing to inflationary pressure.*" The 2007 *Budget* notes the 2006/07 fiscal stance as being expansionary to the tune of 0.7 percent of GDP, and 1.9 percent of GDP in 2007/08. Public sector wage growth has generally outstripped private sector wage growth for the past 6 years.

Clearly the RBNZ is concerned about a further potential loosening of the fiscal purse in the lead-up to next year's General Elections. Looking towards 2008/09 – a key focal point for medium-term inflation pressure – the *Budget* fiscal projections assumed the fiscal stance would remain expansionary with an injection of 0.8 percent of GDP. This is less expansionary than 2007/08, but clearly adding to demand pressure at a time inflation is projected to remain elevated. Moreover, in an election-charged environment, and given the Australian experience so far, the risk profile for fiscal stimulus appears all pointed one way, particularly with the Crown Accounts in a stronger position than flagged in the 2007 *Budget*. By making their concerns known early, the RBNZ is possibly trying to manage expectations and send a signal that there may be monetary policy consequences.

Another notable feature of today's assessment was reference to additional pressure from the proposed greenhouse emissions trading scheme, which will lead to higher petrol and energy costs. There are still a lot of unknowns at this stage, and the RBNZ will likely look through the first round impact. But given the still lack of inflation headroom the RBNZ faces, alongside the other inflation risks they see, the RBNZ will want to ensure that any second round impacts will be limited.

The RBNZ continues to see the current level of the OCR as consistent with maintaining inflation within the 1-3 percent target band. Despite the RBNZ's view that inflation risks appear to be mostly headed one way, they are still placing faith in the monetary policy framework, specifically the lags between

when the four OCR tightenings over the first part of this year start to impact on activity, and eventually on inflation. Certainly, the better than expected Q3 CPI outturn has given them some much needed breathing space despite the headline number being dragged lower as a result of some one-offs. **The bottom line is that the RBNZ remains in wait and see mode, but continues to fret about inflation risks.**

Given the one-sided nature of inflation risks, any easings remain a long way off. Financial markets will be back to watching the data. The tenor of some of the data relating to domestic demand (specifically the housing market data and credit growth) will leave the market biased towards lower rates. However, the potentially strong labour market data for Q3 due in November (particularly for wage inflation) and a likely rebound in September retail sales will see the swaps curve hold up, running a rates on hold message – an outcome we believe will please the RBNZ. The currency will be the main release valve for any weakness in the (domestic) data. Expect the market to be particularly sensitive to fiscal policy developments in the lead-up to the *Half-Year Economic and Fiscal Update* in December, which should give some indication of the fiscal parameters in the 2008 *Budget*.

Markets largely shrugged off today's assessment, with the 2-year swap rallying a point but the currency largely unchanged. Such a response suggests that the market is buying into the RBNZ's inflation concerns, and is an indication that the Bank will continue to get traction along the yield curve despite the global rally in interest rates.

Text of OCR Review below

OCR unchanged at 8.25 percent

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

Reserve Bank Governor Alan Bollard said: "The outlook for the New Zealand economy and interest rates remains broadly consistent with the view outlined in the September Monetary Policy Statement. The labour market remains tight, domestic income growth continues to expand on the back of strong commodity prices, and core inflationary pressures persist. On the other hand, there are signs the housing market is moderating.

"Despite ongoing surpluses in the government's operating balance, fiscal policy is contributing to inflationary pressure. Any further easing in fiscal policy beyond that already announced will add further upside risks to medium-term inflation.

"There are a number of other upside risks to inflation, including the direct effects of the proposed greenhouse emissions trading scheme and rising global food prices.

"While the turbulence in global financial markets has eased somewhat, considerable uncertainty remains. This poses a downside risk for our key trading partner economies. In addition, the New Zealand dollar remains relatively high, restraining the externally-focused sectors of the economy.

"We believe that the current level of the OCR remains consistent with future inflation outcomes of 1 to 3 percent on average over the medium term."

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