

NEW ZEALAND ECONOMICS RBNZ SEPTEMBER *MPS* REVIEW

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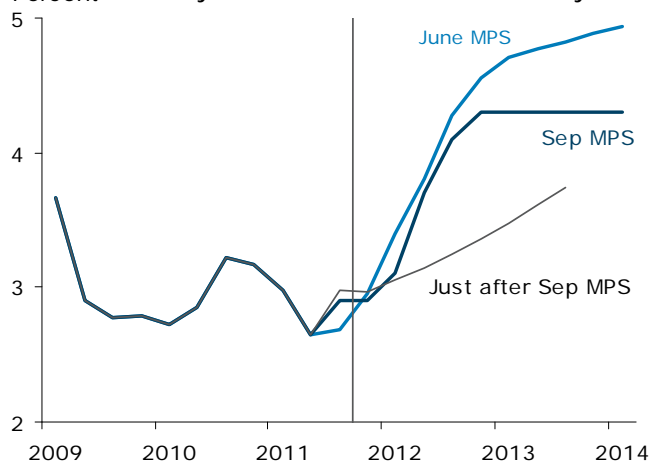
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PLAYING IT SAFE

KEY POINTS

- The RBNZ left the OCR unchanged at 2.5 percent as expected.
- While the domestic economy has performed better than the RBNZ expected, the deteriorating global situation is the key focus for the RBNZ at present.
- If not for the global scene, the RBNZ would likely have hiked rates today. The Bank still expects to increase the OCR at some point, but this will be conditional on how global developments impact on the New Zealand economy.
- For now, the RBNZ is in no hurry. Their 90-day interest rate projections imply an early 2012 start to the tightening cycle, with a lower endpoint of 4.3 percent (compared to 4.9 percent in the June projections). This fits with our long-held view that the neutral OCR rate is lower due to the structural change in bank funding costs – a view the RBNZ is now coming around to.
- We are keeping a close eye on commodity prices, confidence and bank deposit rates, which we see as the key transmission channels from offshore to New Zealand. If all three remain stable and show no material signs of being affected by global developments, then there is little reason to keep the OCR at 2.5 percent for too long.
- We see little point ducking and diving at present over the timing of the first move. Suffice to say we think the spirit of our interest rate assessment is what matters. And the message here is simple. The bias for interest rates is up. It will be slow and gradual, full of fits, stops and starts.

Percent **90-day bank bill futures and MPS 90-day track**



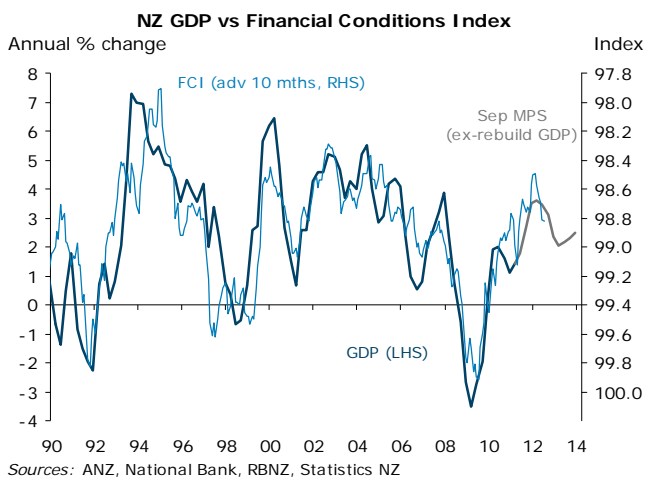
Sources: ANZ, National Bank, RBNZ.

DATA REVIEW

COMMENT AND ASSESSMENT

The RBNZ played a safe hand today in leaving the OCR unchanged at 2.5 percent. In rugby parlance, the RBNZ kicked for touch. As we have noted, if it were not for the deteriorating global outlook and financial market volatility – in particular, a sharp lift in offshore funding costs – the RBNZ would have hiked today. The Bank acknowledges the better-performing domestic economy and higher inflation outturn compared to their June projections. In addition, they note that capacity usage has increased, with the degree of slack much less pronounced than it was in the trough of the recession. Normally, an assessment of reducing spare capacity and ongoing recovery would presage inflation pressures, necessitating a higher OCR. But domestic considerations are being trumped by the deteriorating global outlook.

The impact from the global scene on New Zealand has been minimal to date, though it is early days yet. There is a high degree of uncertainty over how the global situation will evolve, and what impact that will have on New Zealand. The RBNZ do not profess to have the answer. No one does. But a key judgement they have made is that bank funding costs will stay elevated throughout the projection period, and together with a higher NZD, result in tighter financial conditions. This is something to which we have alluded in recent weeks, with our financial conditions index suggesting that the widening in bank CDS spreads could potentially shave one percentage point off GDP growth, though of course this has been mitigated somewhat by lower wholesale rates and an easing currency. We note that the RBNZ's September *Monetary Policy Statement* GDP growth forecasts (ex-rebuild) is consistent with what our financial conditions index is flagging.



The issue of bank funding was very prominent in the *Monetary Policy Statement*, getting thirteen mentions. This is clearly an area that the RBNZ is monitoring very closely. While bank CDS spreads are approaching levels seen in early 2009, there are some specific aspects at play to be mindful of. The move has been exaggerated by a lack of liquidity in the derivatives market, with the spread on traditional cash bonds not as pronounced. Nonetheless, if conditions do not improve, then eventually, bank funding costs will rise.

In our view, the RBNZ is in the unfortunate position of knowing that:

- there are clear domestic fundamentals pointing to a higher OCR, including a natural disaster (which tend to be inflationary), diminished supply side capacity across the economy, and rising capacity utilisation as momentum improves; and
- the global scene promises to be full of more flip flops than you would usually find at Bondi beach over the coming years. You don't get out of a financial crisis in a couple of years, and our sovereign risk analysis has been saying the same, with Europe the centre of attention. This means funding markets are going to remain fickle and volatile, oscillating from wide (expensive relative to normal) to extreme (think obscenely expensive). For a small open economy dependent on offshore credit, this is hugely significant.

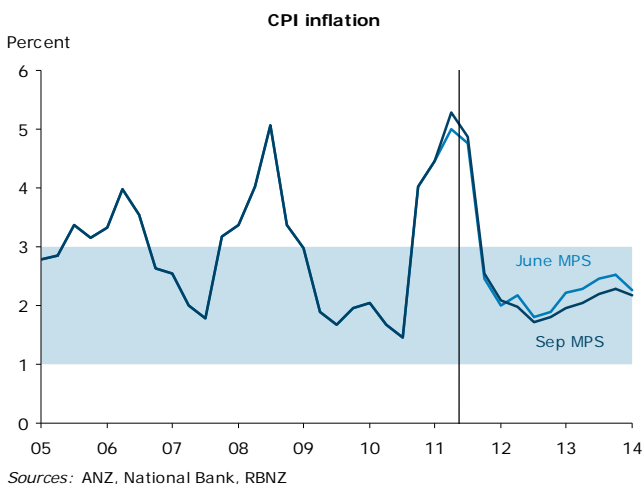
The latter channel will influence not only the timing of the tightening cycle but also the endgame. Certainly, we have seen a structural shift in funding costs internationally, and a shift in the balance of power globally from borrowers towards savers and investors, which will also be intertwined with bouts of risk-on and risk off over the coming years. In this environment the endgame for the OCR over the next few years looks no higher than 4.5 percent. The fact the RBA cash rate looks to have topped out at 4.75 percent is telling.

Picking the timing of the tightening cycle looks more problematic. Domestic interest rates still look too low relative to the local inflation and growth outlook. The profile of the RBNZ's 90-day interest rate track implies an early 2012 start to the tightening cycle. In addition, the RBNZ has stepped away from talking about the "insurance cut" in March, which we take to mean a 50bps unwind is off the table (for now). Even if the global scene settles, it will hardly be stable, so some caution will be warranted when unwinding policy support.

DATA REVIEW

We see stabilisation and improvement in offshore funding markets as a prerequisite to higher interest rates (i.e. the RBNZ will not want to be hiking when funding costs are going up at the same time). Given the scale of Europe's challenges, it seems heroic to think things could be improving by year-end, though policymakers could yet pull a rabbit out of the hat. In this situation **the risk profile is clearly tilted towards a March 2012 hike over December 2011**. We strongly suspect inflation indicators will favour the earlier start, with upcoming data such as the Q3 unemployment rate, Q3 CPI and the next inflation expectations readings supporting this. However, tail-risks in the global scene will urge some chance being taken on the inflation trajectory. Facing huge asymmetric risks in the financial system, brace for more inflation to grease the wheels of the economy, though we expect (hope!) the inflation genie will remain in the bottle. Welcome to the world where policymakers, including central banks, face heightened tradeoffs within their reaction functions.

We also note that the RBNZ now describes underlying inflation as being near 2 percent this time, as opposed to "below 2.5 percent" in the July Review. Has anything new emerged to support this? Not really. Rather we think this corrects a boo-boo in the July Review, as references to 2.5 percent implied some comfort with inflation in the upper part of the band as opposed to the mid-point.

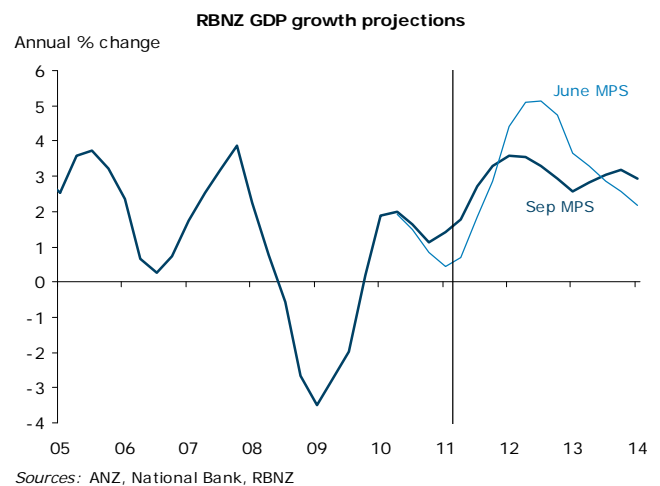


We see little point ducking and diving at present trying to pin down the exact starting date for the hiking cycle. There is simply too much going on. Suffice to say we think the spirit of our interest rate assessment is what matters. And the message here is simple. The bias for the OCR is up. It will be slow and gradual, full of fits, stops and starts.

The key things to watch, in our view, will be the transmission channels from the global

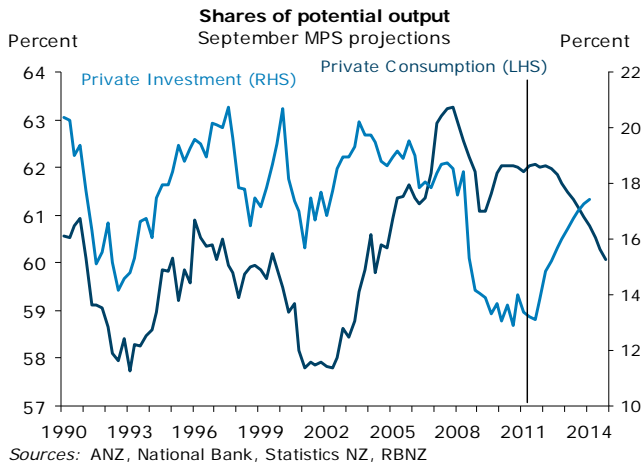
environment to New Zealand. Specifically, we are closely watching commodity prices, confidence, and domestic deposit rates. To date, all three have not seen much impact from global wobbles. But should financial market confidence deteriorate further leading to an actual escalation in bank funding costs, then we expect to see domestic deposit rates move higher – which will be a telltale sign that some of the transmission is starting to flow through.

Turning to the RBNZ's economic projections, GDP growth is weaker over 2012 compared to the June projections. A weaker global growth outlook, tighter financial conditions and a delay in earthquake reconstruction are the main reasons behind the changed outlook. The weaker growth profile and higher assumed TWI result in lower CPI inflation over the projection period. We see upside risk to the RBNZ's inflation forecasts over the near-term. In addition, we have factored in stronger growth over the second half of this year compared to the RBNZ, as we anticipate that the Rugby World Cup impact will significantly boost economic activity. The difficulty for the RBNZ is in trying to separate the impact of the Rugby World Cup from underlying base momentum. This may not be apparent until early next year.



The Bank's projections also implicitly assume private consumption will remain tepid to make way for the rebuilding of the nationwide capital stock, with a box in the *Monetary Policy Statement* discussing why the apparent degree of resource slack is much less pronounced this time around. Whether consumers will continue to exercise such restraint remains to be seen, particularly with the labour market starting to firm. If they do not, RBNZ projections for the current account deficit, activity and inflation would then take on a much less benign tone.

DATA REVIEW



We expect the economic data over the coming months to continue holding up reasonably well.

Today's PMI reading, for instance, saw only a small fall from 53.2 to 52.9, faring better than global gauges. Confidence measures have also held up well over August, and the readings over the next couple of months will be revealing. Should they stay robust, it will lead to some tension in terms of what the RBNZ should be doing in December (i.e. responding to what they know, versus what could happen).

IMPLICATIONS

The RBNZ is leaving its options open. The next move in the OCR is still up, but the timing is dependent on the global scene stabilising, and when that might be is anyone's guess. The key message is that we are in for a long and slow tightening cycle, with a lower OCR endpoint than historical norms would suggest.

RBNZ SEPTEMBER 2011 MPS PROJECTIONS (JUNE 2011 MPS IN BRACKETS)				
	90-DAY	TWI (QTR AVERAGE)	CPI (ANN % CHG)	GDP (ANN % CHG)
Q1 2011	3.0	67.1	4.5	1.4 (0.4)
Q2	2.7 (2.6)	69.1 (68.8)	5.3 (5.0)	1.8 (0.7)
Q3	2.9 (2.7)	72.5 (68.5)	4.9 (4.8)	2.7 (1.8)
Q4	2.9 (3.0)	72.4 (68.6)	2.6 (2.5)	3.3 (2.9)
Q1 2012	3.1 (3.4)	72.4 (68.5)	2.1 (2.0)	3.6 (4.4)
Q2	3.7 (3.8)	72.1 (68.4)	2.0 (2.2)	3.5 (5.1)
Q3	4.1 (4.3)	71.7 (68.1)	1.7 (1.8)	3.3 (5.1)
Q4	4.3 (4.6)	71.1 (67.8)	1.8 (1.9)	2.9 (4.7)
Q1 2013	4.3 (4.7)	70.6 (67.5)	2.0 (2.2)	2.6 (3.6)
Q2	4.3 (4.8)	70.3 (67.2)	2.0 (2.3)	2.8 (3.3)
Q3	4.3 (4.8)	69.8 (66.9)	2.2 (2.4)	3.1 (2.9)
Q4	4.3 (4.9)	69.4 (66.5)	2.3 (2.5)	3.2 (2.6)
Q1 2014	4.3 (4.9)	69.0 (66.0)	2.2 (2.3)	2.9 (2.2)

SEPTEMBER 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: "The New Zealand economy has performed relatively well while headline inflation has increased somewhat since the June Statement. At the same time, however, global economic and financial risks have increased.

"Domestic economic activity has surprised on the upside and capacity usage appears to have increased. Continued high export commodity prices and, in time, reconstruction in Canterbury are expected to provide impetus to demand over the projection horizon.

"However, the outlook for New Zealand's trading partners has deteriorated markedly. There is now a real risk that global economic activity slows sharply.

"Global financial market sentiment has also deteriorated. Sovereign debt concerns in Europe and the weakened global outlook have caused international bank funding markets to tighten. If conditions do not improve, New Zealand bank funding costs will increase.

"Largely because the New Zealand economy has been doing better than many others, the New Zealand dollar has appreciated since the June Statement. The high level of the New Zealand dollar is having a dampening influence on some parts of the tradable sector and on imported inflation.

"Annual headline CPI inflation continues to be above the Bank's 1 to 3 percent target band. However, much of the current spike in inflation has been driven by last year's increase in the rate of GST, and will therefore be temporary. Wage and price setters should focus on underlying inflation, which, while rising, is currently estimated to be near 2 percent.

"If recent global developments have only a mild impact on the New Zealand economy, it is likely that the OCR will need to increase. For now, given the recent intensification in global economic and financial risks, it is prudent to continue to hold the OCR at 2.5 percent."

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