

# NEW ZEALAND ECONOMICS

## MARCH *MONETARY POLICY STATEMENT* REVIEW

10 March 2011

### CONTRIBUTORS

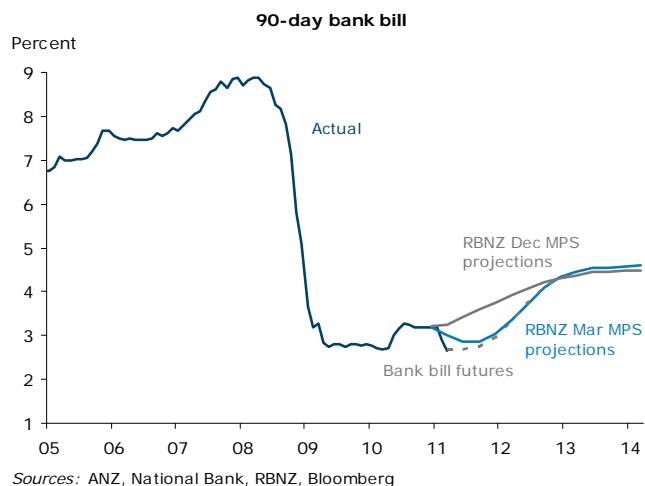
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## RBNZ DELIVERS INSURANCE CUT OF 50BPS

### KEY POINTS

- The RBNZ delivered a 50bps cut, taking the OCR to 2.5 percent.
- The move is an insurance measure in response to the earthquake. The Governor said that “we have acted pre-emptively in reducing the OCR to lessen the economic impact of the earthquake and guard against the risk of this impact becoming especially severe.”
- The RBNZ views the inflation picture as somewhat benign (in fact inflation is not even mentioned in the policy assessment at all), giving scope for additional policy support. The fact that borrowers currently have a short duration of debt gives the RBNZ comfort that looser policy now can quickly be reversed if required. However, this is not without risk.
- Understandably, the level of uncertainty over the economic outlook is far greater than usual. Economic activity will rebound when the earthquake rebuild commences, and when this occurs will be a key judgement.
- Policy looks set to be on hold for most of 2011.
- The RBNZ’s projections flag a succession of 25bp hikes from early 2012 – a faster pace of tightening than expressed 3 months ago, but with a similar endpoint.
- We expect a marginally earlier unwind of policy support relative to the RBNZ. Key differentiating judgments here are that inflation pressures in 2011 are more pronounced than the RBNZ’s projection, and the current earthquake rebuilding response will be quicker than the September experience. Despite more cautious behaviour expected on behalf of consumers, financial conditions are now so supportive that the New Zealand economy has the potential to turn very sharply in late 2011. This effect is broader than and in addition to the pending reconstruction-related boost.



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## COMMENT AND ASSESSMENT

**The RBNZ delivered a pre-emptive rate cut of 50bps today, taking the OCR to 2.5 percent.**

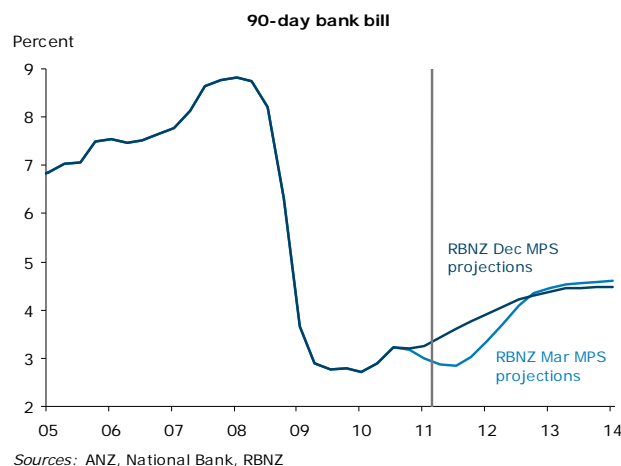
Even prior to the February 22 earthquake, economic activity had been weaker than the RBNZ had projected at the time of the December *Monetary Policy Statement* (MPS). The RBNZ noted that more recently, signs of recovery had begun to emerge and "the Bank's January round of business visits was surprisingly positive". This was consistent with the anecdotes we had been receiving and ties in with the inflection point view of the economy we had been running over February. The earthquake however, has changed the landscape.

**Today's rate cut should be seen as the RBNZ taking an insurance measure.** Given the uncertainty surrounding the exact impact of the earthquake on the economic outlook, the RBNZ has had to rely on a lot of assumptions and judgements based on imperfect information. But the broad spirit of their assessment is that economic activity will be much weaker over H1 2011 (with Q1 GDP 0.6ppts lower due to the quake), before rebuilding sees strong growth from later in the year.

**As such, the additional policy support is to shore up confidence and help the country manage the near-term disruptions caused by the earthquake.** Fiscal policy is the main policy tool during times of natural disaster, but monetary policy is also playing a vital supporting role. The weaker starting position of the economy, the positively sloped shape of the yield curve and well-contained inflation (excluding GST and policy effects) has given the RBNZ confidence to act aggressively today. With almost half of all mortgages now on floating rates, **the RBNZ takes great comfort in knowing that they can remove the insurance rate cuts quickly should the situation warrant it.**

**The March MPS 90-day projection converges to their December MPS track by the end of 2012, and rises slightly higher thereafter.** This implies a much steeper tightening profile when it begins, with hikes at consecutive meetings as opposed to the start-stop nature that was previously flagged. Based on the 90-day track, policy stimulus will be removed from early 2012. However, the timing of this hinges on two things:

- How quickly rebuilding efforts can begin in Christchurch; and
- The inflation profile.



**Rebuilding is likely to face some delays.** Five months on from last September's earthquake, building work was only just beginning to get underway. The list is endless in terms of challenges, including the insurance assessment, getting actual payment, the building consent process and when the aftershocks settle down.

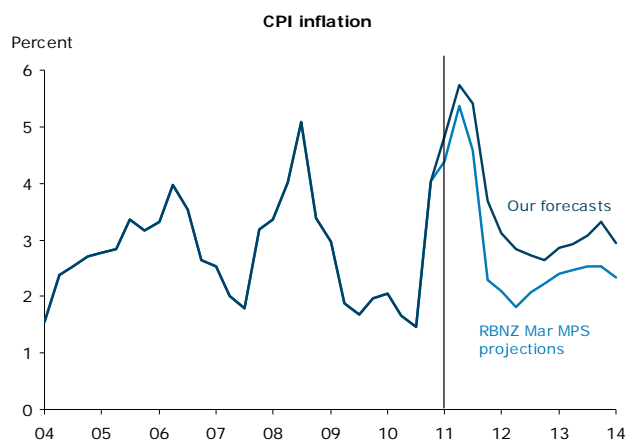
**There are key differences this time around.** The current event is far bigger, so the immediate reconstruction response in terms of restoring key services needed to be, and has been, far quicker. We are already seeing strong demand for replacement premises. The central government has taken over co-ordination of the rebuild, which should ensure more speedy decision-making and better allocation of resources. People are on the ground immediately this time around. This does not mean we expect a gung-ho residential-related ramp up in activity quickly. There will be challenges and delays via bottlenecks such as having sufficient assessors. But in an election year, there seems every incentive under the sun to make sure the rebuild profile and coordinated action proceeds quickly as opposed to being stymied. We await further constructive steps from fiscal policy, which needs to do most of the heavy lifting. We would not be surprised to see a new vehicle announced that will take a more direct governance role to ensure more seamless decision making.

**On the inflation front, our view is less benign than the RBNZ's projections.** We believe there are clear upside risks to the RBNZ's inflation forecasts in the near term, stemming from higher energy prices. Indeed, when we work out the RBNZ's implied quarterly CPI profile for this year, we get 0.7 percent for Q1, 1.1 percent for Q2, 0.4 percent for Q3 and 0.1 percent for Q4. Lower

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numbers in the second half of the year are critical: the RBNZ needs low figures to see the headline CPI head back into the target band (and when the GST-induced CPI surge in December 2010 falls out of the calculation). Such quarterly outturns, in the absence of a sharp correction in commodity prices (which to be fair is something we wonder about if policymakers across the G7 start to unwind excess liquidity), look a stretch.

To be fair, the RBNZ finalised their forecasts before the 13c/ltr hike in petrol prices. But even excluding that, **the Bank's medium-term inflation forecasts, which settle around 2.2 percent, look far too light given the known upside pressures to prices that are looming.** The RBNZ noted that there will be temporary increases in rents, and that insurance premiums will rise nationwide as a result of the earthquake. In addition, construction-related costs will also rise, given the size of the rebuild. Throw on top of that higher energy and food prices, and we easily see medium-term inflation settling towards the top of the RBNZ's target band rather than closer to the mid-point.



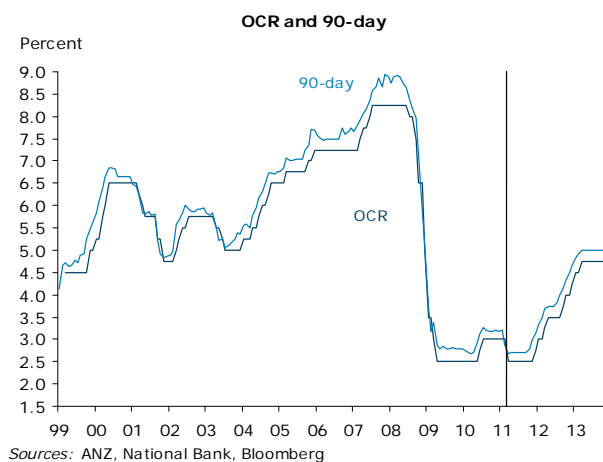
Sources: ANZ, National Bank, RBNZ

**For now, inflation is not a predominant concern for the RBNZ, with the focus more on ensuring that the economy remains supported in the near-term. This is appropriate,** and reflected in the fact that the policy assessment mentions the word "earthquake" five times and inflation not even once. For now the policy response is directed at supporting the economy's near-term prospects. The RBNZ is prepared to risk falling behind the curve, on the basis that the positively sloped yield curve and high proportion of borrowers on variable rates gives them greater policy traction when they do move.

**The pre-emptive nature of today's cut also suggests that the RBNZ is anticipating some weak economic data, which is expected to appear over the next few months.** As such, economic activity would need to deteriorate markedly in order for the RBNZ to ease rates further. We think the odds of this are small, and in subsequent commentary the Governor pretty much ruled out the potential for a further cut.

## IMPLICATIONS

**We see policy as now on hold, and the RBNZ will be in data assessment mode.** We have pencilled in the first rate hike for December 2011, given our view that inflation will prove less benign than the RBNZ has projected, and that the economy has the potential to turn more sharply in the latter part of 2011. Indeed, a combination of the Rugby World Cup activity, the ramping up in reconstruction work and the diffusion of a massive terms of trade boost looks set to boost economic activity late in the year.



Sources: ANZ, National Bank, Bloomberg

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## RBNZ'S POLICY ASSESSMENT

The Reserve Bank today reduced the Official Cash Rate (OCR) by 50 basis points to 2.5 percent.

Reserve Bank Governor Alan Bollard said: "The Reserve Bank extends its sympathies to all those affected by the Christchurch earthquake. Our condolences go especially to those who have lost family, friends and colleagues.

"The earthquake has caused substantial damage to property and buildings, and immense disruption to business activity. While it is difficult to know exactly how large or long-lasting these effects will be, it is clear that economic activity, most certainly in Christchurch but also nationwide, will be negatively impacted. Business and consumer confidence has almost certainly deteriorated.

"Even before the earthquake, GDP growth was much weaker than expected through the second half of 2010. Households have continued to be very cautious, with retail spending volumes and residential investment both declining. The export sector has benefited from very high commodity prices, however, farmers have focused on repaying debt rather than increasing spending. Also the early summer drought constrained farm output through this time. Signs that the economy was beginning to recover early in 2011 have been more than offset by the Christchurch earthquake.

"In putting together the forecasts underlying this Monetary Policy Statement, the Bank has had to make many important assumptions based on limited information. Over the coming weeks and months, these judgments will be tested as new information comes to hand. For now, GDP growth is projected to be quite weak through the first half of the year. This will gradually build up to a very large reconstruction programme by 2012 that will last for some years and contribute to a period of relatively strong activity.

"Future monetary policy adjustments will be guided by emerging economic data. We expect that the current monetary policy accommodation will need to be removed once the rebuilding phase materialises. This will take some time. For now we have acted pre-emptively in reducing the OCR to lessen the economic impact of the earthquake and guard against the risk of this impact becoming especially severe."

## RBNZ MARCH 2011 MPS PROJECTIONS (DECEMBER 2010 MPS IN BRACKETS)

	90-DAY	TWI (YEAR AVERAGE)	CPI (ANN % CHG)	GDP (ANN AVE % CHG)
Q1 2011	3.0 (3.3)	67.5(67.7)	4.4 (4.3)	0.9 (1.7)
Q2	2.9 (3.4)		5.4 (5.0)	0.6 (1.7)
Q3	2.9 (3.6)		4.6 (4.3)	0.7 (2.1)
Q4	3.0 (3.8)		2.3 (2.1)	1.3 (2.7)
Q1 2012	3.4 (3.9)	67.1 (67.4)	2.1 (2.1)	2.7 (3.4)
Q2	3.7 (4.1)		1.8 (2.1)	4.0 (3.8)
Q3	4.1 (4.2)		2.1 (2.2)	5.0 (3.7)
Q4	4.3 (4.3)		2.2 (2.2)	5.4 (3.3)
Q1 2013	4.5 (4.4)	65.2 (65.6)	2.4 (2.2)	4.7 (2.8)
Q2	4.5 (4.5)		2.5 (2.3)	3.7 (2.3)
Q3	4.6 (4.5)		2.5 (2.3)	2.7 (1.9)
Q4	4.6 (4.5)		2.5 (2.2)	2.0 (1.8)
Q1 2014	4.6 (4.5)	63.5 (..)	2.3 (1.9)	1.9 (1.8)

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- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

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- Equity securities such as listed and unlisted shares;
- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

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If you wish to pay investment money to the Bank you can do this in several ways such as by:

- Providing cash;
- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

Investment property (other than money) may be delivered to the Bank by lodging the relevant property (for example, share certificates) with any branch of the Bank offering a safe custody service, or by posting (using registered post) the documents or other property to a branch of the Bank, identifying your name, account number and investment purpose.

Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

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The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

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