

Economic Review

New Zealand

29 October 2009

RBNZ October OCR Review

Key points

- > **The RBNZ left the OCR unchanged at 2.5 percent and dropped their soft easing bias from September, moving to a neutral stance.**
- > **But the RBNZ sees no urgency in lifting rates, still expecting to keep the OCR at current levels until the second half of 2010.**
- > **The interaction between fiscal and monetary policy was noted, with a consolidation in the former *“likely to reduce the work that monetary policy will otherwise need to do.”***
- > **We remain comfortable with our call of a September start to the tightening cycle, but with 50 basis point moves from that point.**

Assessment

Today’s no change to the OCR at 2.5 percent was widely anticipated. The main focus was on whether the RBNZ would drop their soft easing bias from the September statement (the *“at or below”* phrase), and whether the Bank’s commitment to keeping rates low until the latter part of 2010 would be dropped.

The RBNZ has moved to a neutral stance, with the easing bias removed as we had expected.

The improvement seen in the economy – and in interest rate sensitive sectors, along with the global scene – argued strongly for a more neutral demeanour. While the improvement is acknowledged and welcomed by the RBNZ, they remain cautious, noting *“significant vulnerabilities and challenges to be worked through”* in many economies, which could weigh on global growth going forward. Domestically, the RBNZ notes business spending remains weak and credit growth very subdued. The high NZD is seen as limiting the scope of exports to contribute to the recovery. The composition of growth (domestic demand driven) has the RBNZ – like ourselves – raising questions about its sustainability.

Inflation and the rebound in the housing market are not areas of concern for the RBNZ at present. The market may have gotten all excited over the strong Q3 CPI print, but the RBNZ does not appear at all concerned, noting that inflation is still expected to track comfortably within the target band. Similarly, with the housing market, recent price increases were noted but no concern expressed. **One indicator to track closely in coming months, however, is credit growth.** The RBNZ will grow more concerned over the sustainability of the recovery if credit growth began to propel stronger domestic demand.

In a very direct way, the RBNZ has flagged that current market pricing of early 2010 rate hikes is premature. The RBNZ sees no urgency to begin withdrawing monetary policy stimulus. Importantly, **the RBNZ noted the interaction between fiscal and monetary policy, something that we had alluded to in our recent research.** With the process of fiscal consolidation underway, fiscal policy will provide less support to the economy going forward. This allows monetary policy to remain more accommodative for longer as a result. Therefore, the upcoming *Budget Policy Statement* in December, which will outline the government’s intentions for next year’s budget, will take on added significance.

The RBNZ still expects to keep the OCR at current levels until the second half of 2010. This is a slight change from the September statement’s *“latter part of 2010”*. Implicitly, this gives the RBNZ more flexibility to move earlier should conditions warrant (the September MPS projections had the 90-day rate rising from December 2010). But the main message is clear. The RBNZ is on hold for some time.

Implications

We remain comfortable with our call of a September start to the tightening cycle. We share the RBNZ’s caution over the economic outlook, and see a need for keeping rates on hold for some time. In our view, financial conditions are not as loose as what a 2.5 percent OCR implies. The high currency and rising longer term fixed mortgage rates have been doing some tightening work for the RBNZ over recent months. In addition, fiscal policy will start becoming more contractionary over the year ahead. This leaves the RBNZ having to provide support for longer. But

a lower for longer stance will invariably bring more aggressive moves when the process of policy normalisation is required. This means 50 basis point moves in the first few instances. In this regard, we now see the neutral OCR residing closer to 5 percent than 6 percent, given structural changes in some areas including margins and the shape of the yield curve. We expect the neutral level to be the first target when the RBNZ decides to normalise policy.

Text of OCR review:

The Official Cash Rate (OCR) remains unchanged at 2.5 percent.

Reserve Bank Governor Alan Bollard said: "There are welcome signs that economic activity is growing again.

"Activity in New Zealand's trading partners continued to rebound during the September quarter and financial market sentiment has improved further. However, there remain significant vulnerabilities and challenges to be worked through in many economies. This process could weigh on global growth going forward.

"In New Zealand, the housing market has reversed some of the decline in prices experienced over the past couple of years and a very gradual increase in household spending appears to be taking place. Government spending is also supporting activity. Business spending, however, remains weak and credit growth is very subdued.

"The high level of the New Zealand dollar has limited the scope for exports to contribute to the recovery, and reinforces a bias towards domestic expenditure. After some short-term correction it is also likely to see the current account deficit begin to widen in the medium term.

"The current composition of growth continues to raise questions about its sustainability. These concerns would intensify if credit growth began to propel stronger domestic demand.

"Annual CPI inflation is expected to continue to track comfortably within the target range over the medium term.

"The forecast recovery in economic activity is based on fiscal and monetary policy continuing to provide substantial support to the economy. We think such support remains appropriate. Further ahead, removing some of the current fiscal stimulus is likely to reduce the work that monetary policy will otherwise need to do.

"In contrast to current market pricing, we see no urgency to begin withdrawing monetary policy stimulus, and we expect to keep the OCR at the current level until the second half of 2010."

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- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
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