
RESERVE BANK OFFICIAL CASH RATE REVIEW

Key points

- The RBNZ increased the OCR by 25 basis points to 7.75 percent as we had expected, with inflation risks dominating the material tightening in financial conditions that had already occurred and forcing the Governor's hand.
- The statement lacks direction on the bias for policy but still looks to contain a soft tightening bias. The tone of the statement indicates that the hurdle to another hike is very high with the Bank likely preferring to see concrete evidence of the impact of the recent tightening in financial conditions on the economy.
- A significant aspect to the statement was explicit reference to the high NZD, which the Reserve Bank describes as unjustified by economic fundamentals.
- Collectively, it looks like a statement that implicitly acknowledges the inflation risk profile, seeks to gain policy traction by anchoring the yield curve, but without delivering a calamitous impact on the export sector via the NZD.
- We believe that today's tightening will be the last in this current cycle. But any easing is a long way off.

Assessment

The resurgence in economic activity late last year and early this year, and recent signs of re-acceleration in non-tradables inflation, looks to have forced the Governor's hand today despite the material tightening in financial conditions that had already occurred. Strength in domestic demand is explicitly noted, along with inflation trends although the high level of the exchange rate is a countering factor, and the recent rapid rise in fixed lending rates was explicitly mentioned in the text.

The statement does, however, contain softer nuances. The strength in domestic demand fuelled by the housing market, expansionary fiscal policy, rising commodity prices, net migration gains and a tight labour market continues to concern the RBNZ. Pressure on resources and the re-acceleration in non-tradable inflation was cited. Yet the statement did not explicitly mention any risks to medium-term inflation pressures, which the previous two statements touched on. In fact, the RBNZ sees the exchange rate as helping to exert downward pressure on medium-term inflation. **There is a lack of clear bias going forward.** Any references to "further tightening" or any conditions placed on a moderation in domestic demand were absent. Implicitly, the Reserve Bank appears of the view that the recent tightening in financial conditions will prove sufficient to dampen medium-term inflation pressure.

A soft tightening bias still looks to be in place. While today's statement does not provide the market with any direction on the bias for future policy moves, it should not be read as an indication that the RBNZ is in neutral mode. The tenor of upcoming data will still be important, particularly relating to the housing market and domestic demand, although the hurdle to a rate hike in June now looks very high. Both the rates and currency markets will continue to move in line with the dataflow, but we believe that today's tightening will be the last in this current cycle. However, any easing in policy is still a long way off. Q1 HLFS (due 10 May) is likely to be key, along with the 2007 Budget (17 May) and early indicators of momentum in Q2.

The RBNZ describes the exchange rate as unjustified based on medium-term fundamentals, although it notes that sharp increases in world dairy prices provide some offset and tourist arrivals (which tend to be exchange rate sensitive) continue to grow. Reading between the lines this looks aimed at ensuring the pipeline tightening remains, but without delivering excessive bitter medicine to exporters via a rocketing currency. Moreover, we suspect it may lead to speculation the RBNZ is getting closer to currency intervention, although we believe such intervention will remain some way off given the level of commodity prices.

Financial Market Reaction

The NZD/USD spiked up 45 pips immediately following the interest rate decision, but sharply reversed those gains once the tenor of the statement emerged. The NZD/USD remains choppy as the market continues to digest the statement. Yields in the swaps curve were up by between 1 and 3 basis points, which will please the

RBNZ as it ensures that the pipeline tightening they are relying on to ease domestic demand is maintained. The first and second bank bill futures were down 6 basis points, as the market has reduced the chances of a follow-up hike.

Text of OCR Review below

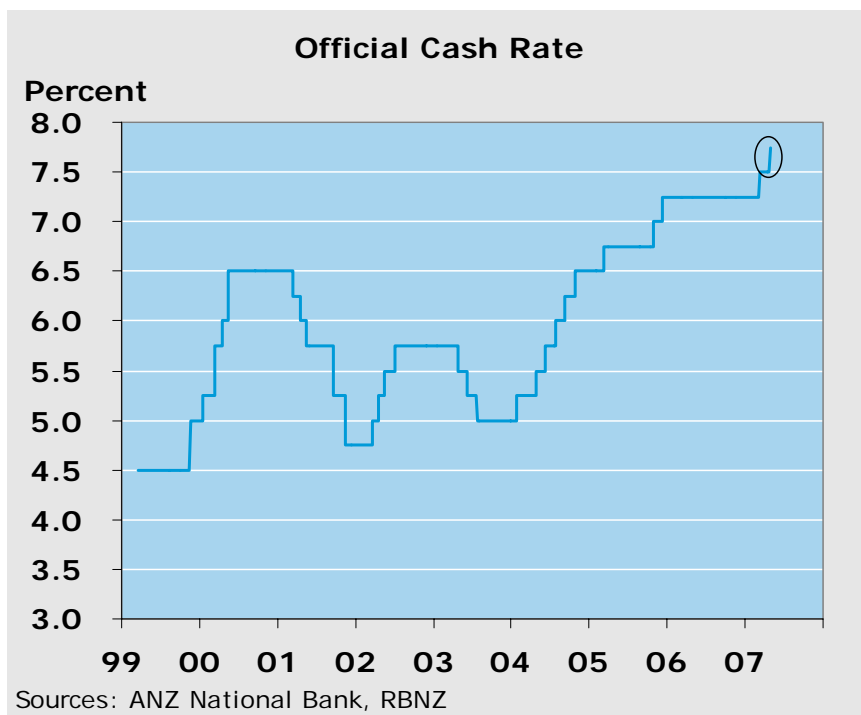
The Official Cash Rate (OCR) will increase by 25 basis points to 7.75 percent.

Recent indicators confirm that the resurgence in economic activity that began in late 2006 has continued over recent months, with domestic demand continuing to expand strongly. As we noted in March, demand is being fuelled by a buoyant housing market, increases in government expenditure, a rising terms of trade, ongoing net immigration, and a robust labour market.

The lift in domestic demand is placing further pressure on already-stretched productive resources. Firms report that capacity is very stretched and that they are again experiencing increased difficulty in finding both skilled and unskilled staff. Consistent with these pressures, non-tradables inflation has remained persistently strong and has recently shown signs of re-acceleration.

The trade-weighted exchange rate has risen further, which will exert some downward pressure on medium-term inflation. The exchange rate is now at levels that are both exceptional by historical standards, and unjustified on the basis of medium-term fundamentals. Parts of the export sector continue to face challenging conditions, but the recent sharp lift in world dairy prices is expected to provide a boost to incomes in that sector and tourist arrivals are continuing to grow.

There has already been a recent rise in fixed mortgage interest rates. This further increase in the OCR is aimed at ensuring that inflation outcomes remain consistent with achieving the target of 1 to 3 percent inflation on average over the medium term.



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