

NEW ZEALAND ECONOMICS

RBNZ OCR REVIEW

27 January 2011

CONTRIBUTORS

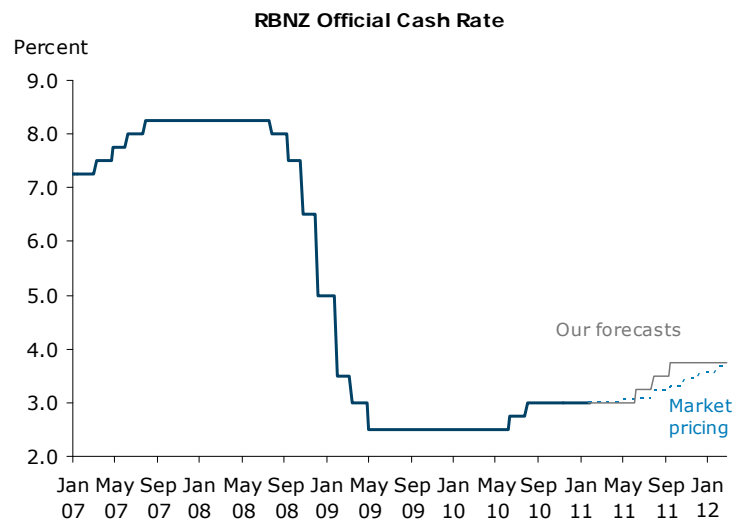
Cameron Bagrie
Chief Economist
 Telephone: +64 4 802 2212
 E-mail: Cameron.Bagrie@anz.com

Khoon Goh
Head of Market Economics and Strategy
 Telephone: +64 4 802 2357
 E-mail: Khoon.Goh@anz.com

RBNZ MAINTAINS DECEMBER STANCE

KEY POINTS

- The RBNZ left the OCR unchanged at 3 percent as widely expected.
- The tone of the press release was similar to their December stance, though less downbeat relative to what the market was expecting.
- While acknowledging weaker data of late, the RBNZ continues to expect future activity to pick up, helped by trading partner growth and high commodity prices.
- We concur and expect a stronger springboard effect to growth following H2 2010 weakness.
- Inflation is not a concern for the RBNZ at present, though we suspect rising food and energy prices will start to bring inflation onto the RBNZ's radar screen soon.
- Interestingly, there was no mention of the currency or fiscal policy. With fiscal policy set to be tighter than expected, this certainly leaves scope for the RBNZ to keep policy more accommodative for longer.
- All up, a "safe" statement to start the year. We still expect a mid-year start to the tightening cycle based on our less sanguine view on inflation and signs of more robust growth emerging from Q2 this year. Though looking for an earlier start, we nonetheless concur with the view that rates will not move up aggressively and the end-point will be lower compared to previous cycles.

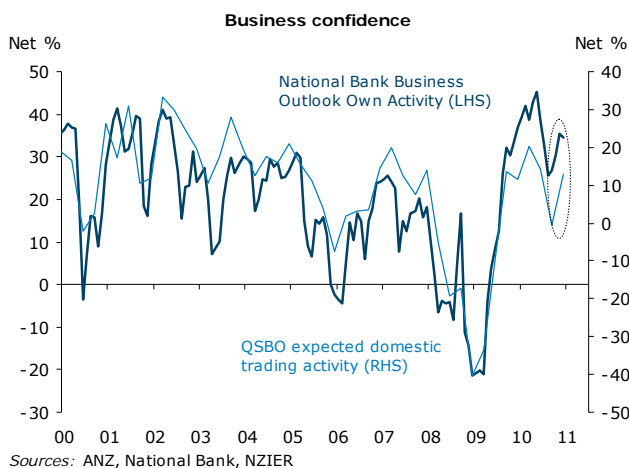


RBNZ OCR REVIEW

COMMENT AND ASSESSMENT

The RBNZ kept the OCR unchanged today at 3 percent. This decision was widely expected. The press release accompanying the decision was short, and largely reiterated their December *Monetary Policy Statement* (MPS) stance. Although the economic dataflow since the December MPS has been weaker than the RBNZ had forecast – in particular the contraction in Q3 2010 GDP and ongoing weak retail sales data – these surprises have not been material enough to cause the RBNZ to shift their view on the outlook.

A weaker starting position over H2 2010 is countered somewhat by a firming in lead indicators. Business confidence has picked up, and stronger imports of investment goods are a promising sign of improving business spending. Ongoing trading partner growth and record high commodity prices are also set to drive the recovery this year. In addition, the RBNZ note “tentative signs” that the housing market has stabilised, whereas in December they were expecting house prices to “decline a little further”. **Anecdotally, we are detecting a better tone in early 2011 relative to how 2010 closed. However, we are coy about reading too much into this at present.** The improving anecdotes need to extend into February, and we are mindful that we will still be receiving a barrage of data relating to the end of 2010, such as the HLFs employment report, which are unlikely to be positive.

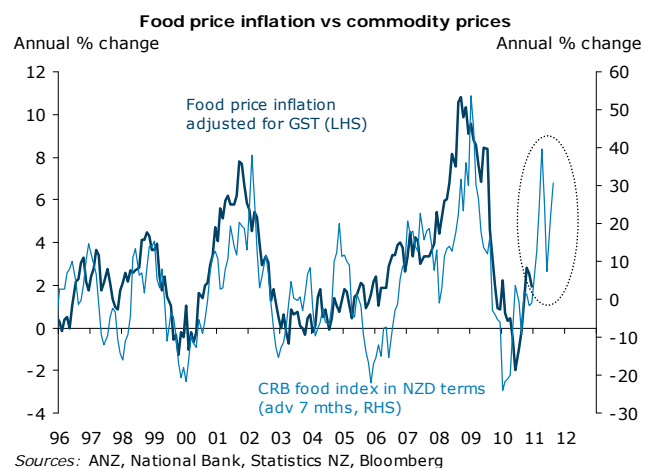


The RBNZ once again wants to see concrete signs of the positive forward indicators translate into hard actual economic activity before responding. After all, the promising rise in business confidence over the early part of last year failed to manifest into reality, with economic activity stalling over Q2 and Q3 2010. The RBNZ reiterated

the sentence from December that “while interest rates are likely to increase modestly over the next two years, for now it seems prudent to keep the OCR low until the recovery becomes more robust and underlying inflationary pressures show more obvious signs of increasing.”

Hence, the onus is on the lead indicators to manifest into hard outturns in order for the recovery to be termed “robust”. On the assumption that improving anecdotes in early 2011 (as distinct from late 2010) do manifest in outcomes, this keeps a potential June move in play. We’ll be closely monitoring our “data surprise” index.

Underlying inflation is not a major concern for the RBNZ at present, though we think it will start to emerge as an issue given rising food and energy-related prices. There is strong upside risk to the RBNZ’s Q1 2011 CPI forecast of 0.6 percent, with higher petrol prices alone likely to add 0.4 percentage points. And with food-related commodity prices rising strongly, we are looking at the prospect of 6-8 percent food inflation by late this year. Therefore, it is important to keep an eye out on inflation expectations for any emerging sign of inflation pressures. **The economy is entering a delicate period** where the “costs” of surging commodity prices are set to emerge in food bills, but the benefits to the rural sector and diffusion to the broader economy are not yet apparent, with weak rural land prices restricting the diffusion process.



The other interesting aspect about today’s statement was what it didn’t say. There was no mention of fiscal policy or the currency, which have featured in various RBNZ comments in 2010. Both remain hugely relevant, though for today the RBNZ appear to have taken a simple approach: don’t overly complicate the situation and

RBNZ OCR REVIEW

keep it short and sweet. It could be that the RBNZ has decided to leave substantive comment on both topics to the March MPS. In any case, we doubt that the RBNZ's view from December on these issues has changed (i.e. currency strength is inhibiting the rebalancing of the economy, and eliminating the fiscal deficit could help improve national savings and ease pressure on interest rates and the currency).

The simple message from today, therefore, is that rates are on hold until we see sustained evidence of a pickup. On that front we're marginally more upbeat relative to the RBNZ's assessment, though we acknowledge that there is probably another 4 to 6 weeks of data relating to late-2010 to absorb and get over first. And the projected rebound we foresee is strongly boosted by "one-offs", and off a low base.

FULL TEXT OF THE OCR PRESS RELEASE

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 3.0 percent.

Reserve Bank Governor Alan Bollard said: "The outlook for the New Zealand economy remains consistent with the projections underlying the December *Monetary Policy Statement*.

"Domestic economic activity was weaker than forecast through the second half of 2010. September quarter GDP declined unexpectedly, and retail spending appears to have fallen in the December quarter.

"Forward indicators of activity have firmed somewhat. Trading partner activity continues to expand and New Zealand's export commodity prices have increased further. Within New Zealand, business confidence, across a range of industries, has picked up and imports of capital equipment have grown. Furthermore, there are tentative signs that housing market activity has stabilised, after having trended lower for some months.

"The recent increase in the rate of GST has caused headline CPI inflation to spike higher as expected, but underlying inflation remains comfortably inside the target band.

"As noted previously, while interest rates are likely to increase modestly over the next two years, for now it seems prudent to keep the OCR low until the recovery becomes more robust and underlying inflationary pressures show more obvious signs of increasing."

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