

RBNZ June *Monetary Policy Statement* Review

Key points

- > The OCR was left unchanged at 8.25 percent as widely expected.
- > The policy assessment was dovish, with the RBNZ now shifting to an easing bias stating *"we are now likely to be in a position to lower the OCR later this year"*.
- > Near-term inflation to be high, but growth picture is so weak that medium-term inflation outlook more favourable.
- > We now expect an easing in September, as the dataflow by then will more or less confirm that the economy went backwards over the first half of this year.
- > Sentiment will now turn to the magnitude of the easing cycle, with a lot dependent on the degree to which the currency adjusts.

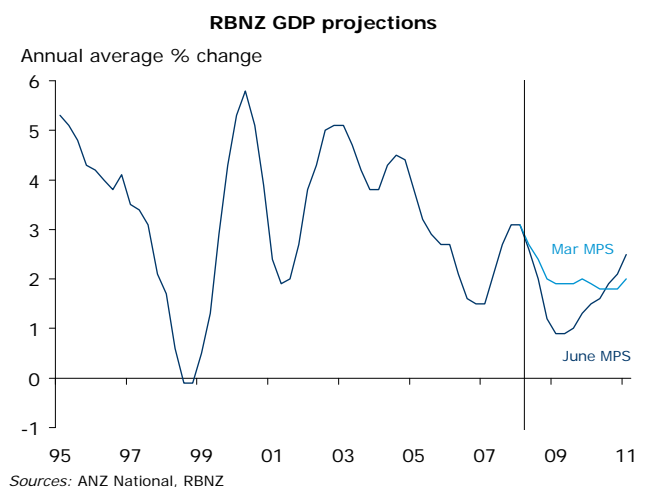
Assessment

The RBNZ left the OCR unchanged but shifted to an easing bias, explicitly signalling *"we are now likely to be in a position to lower the OCR later this year."* However, this is conditional upon the economy continuing to slow and non-tradable inflation starting to ease. While the former is a given going by recent partial data and confidence readings, the latter may continue to be a sticking point. The RBNZ will also want to see inflation and wage expectations stay well anchored.

The growth picture has deteriorated to such a degree that the medium-term outlook for inflation is more favourable. The RBNZ's GDP growth forecasts were revised significantly lower, largely as a result of weak household consumption. Growth over the coming year is anaemic, and as noted by the RBNZ Governor during the press conference, a technical recession cannot be ruled out. While not formally forecasting one, the RBNZ's numbers have growth over H1 going backwards (-0.3 and +0.2 percent GDP growth for Q1 and Q2 respectively). The RBNZ is running a strong household consolidation story and now expects annual house prices to fall by close to 8 percent by the end of this year. Growth remains weak into 2009 and 2010. The additional fiscal stimulus from *Budget 2008* was judged to be relatively small compared to the other headwinds facing the household sector, a view which we concur with. Indeed, despite the tax cuts, the RBNZ expects household consumption growth to effectively be flat over the next couple of years.

In such a weak growth environment, business profitability is poor and as a result, investment and hiring plans are put off. The RBNZ forecasts falling employment for most of the projection period, leading to the unemployment rate steadily rising to 6 percent by Q1 2011. A falling participation rate from a discouraged worker effect prevents the unemployment rate from rising by more. Business investment is

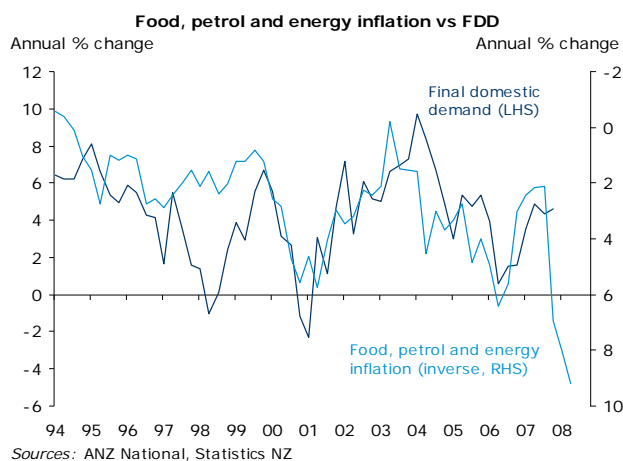
projected to contract over the next couple of years, reflecting tighter credit conditions, a falling exchange rate pushing up the price of imported investment goods, and falling profitability. Residential investment is projected to go through a large cycle as the housing market undergoes a correction.



However, inflationary pressures cannot be completely discounted. Near-term forecasts for inflation have been revised significantly higher, peaking at 4.7 percent in the September quarter. A high inflation rate in turn creates some upside risk to future inflation through increasing inflation expectations (though this was mentioned only in the later chapters rather than in the Key Policy Judgements chapter). Measures of inflation expectations and wage bargaining behaviour need to be closely watched. The Bank's CPI forecast over the next two quarters of 1.4 and 1.3 percent respectively appears to give them some "cover" towards an upside surprise. But a sharp slowdown in growth is expected to see medium-term inflation ease. However, in the near-term, the Bank still sees non-tradable inflation remaining elevated at close to 4 percent until the end of the year.

In some ways the RBNZ's conditional easing profile, at a time when inflation is well above their target band, is an acknowledgement that:

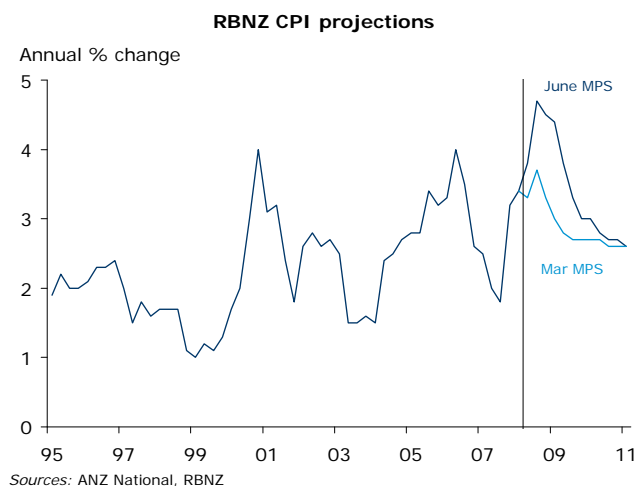
- > The main drivers of the recent price increases (food and energy) are largely outside of their control.
- > These price increases have a dampening effect on economic activity, and therefore on medium-term inflation pressure.
- > The disinflationary effects of weaker growth are more than sufficient to offset the effect that the near-term spike in headline inflation will have on inflation expectations.
- > Workers will not be able to be fully compensated for the higher cost of living pressures from wage increases, given the squeeze on business profitability and a loosening labour market environment.



On the face of it, headline inflation running above 4 percent should not be a major sticking point towards a forward looking central bank cutting rates. After all, the RBNZ hiked rates last year when they were projecting headline inflation to head towards 1.5 percent! But the RBNZ does have to put a lot of faith in the monetary policy framework working well, in that the slowing economic activity will start to dampen medium-term inflation pressures. In this regard, the key dataflow to watch (as explicitly noted by the bank) includes wages and labour market data generally, non-tradable inflation, inflation expectations and capacity utilisation measures.

We agree with the spirit of the RBNZ's forecasts. Like most forecasts it is easy to identify holes. It was a tad surprising to see the unemployment rate head to 6 percent without a recession, and such a prolonged period of weak consumption and GDP growth. Trend labour productivity growth at 2¼ percent still seems optimistic. However, stepping back, the underlying messages are one of rebalancing and an elongated adjustment process as imbalances are purged (the piper is paid), which is similar to the themes apparent in our latest quarterly economic forecasts. Put simply, headwinds from a sustained housing correction and

the flow-on effect on households dwarf the income boost to the economy from fiscal policy and commodity prices.



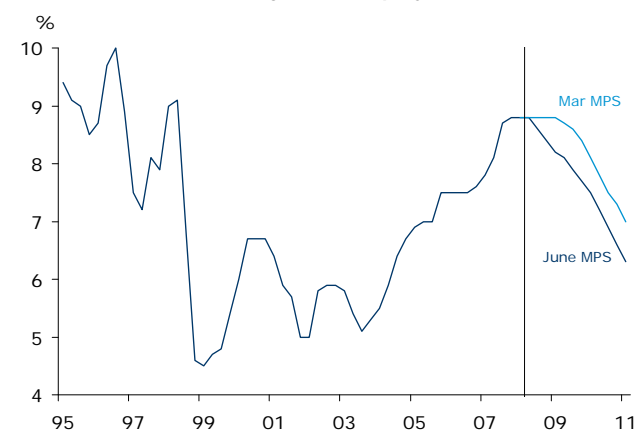
To us, the key issue is not the exact timing of the easing cycle, but the magnitude of the OCR moves. Markets have naturally moved to priced in lower rates from September, and a July move is being speculated. Given the high starting position (200 basis points above neutral) a strong case can be made for an aggressive cycle, where rates are moved lower in sharp order. This is certainly the case if we consider that monetary policy will struggle to gain reflationary traction just as it struggled to dampen momentum at the top of the economic cycle.

However, we also need to be cognisant of the inflationary risks that such an aggressive easing cycle could deliver, particularly if we are already seeing the currency pre-empt the cycle. A five-percent handle on headline inflation may be hard to stomach, and is easily achievable if we see the NZD/USD repeat the 10 cent movements seen in mid-2007 or early 2006. **We suspect the performance of the currency will have a major bearing on not only the timing, but also the magnitude of the rate cuts that can be considered.** While the RBNZ has long expressed a view that the currency was too high and that the Bank would like a lower currency to assist in the rebalancing of the economy, a sharp depreciation will also add more inflation in the near-term.

We believe the interplay between OCR easings and the currency – while a dangerous game to play – will be a significant consideration for the RBNZ going forward. The Bank will be cognisant of the fact that an aggressive easing cycle will cause a sharp fall in the currency, something they will want to avoid. Indeed, the *Statement* noted that *“One of the reasons we are not projecting even more easing in monetary conditions is because the experience of the 1970s warns us of the danger associated with easing monetary conditions too rapidly in the face of sharp oil price increases”*. The last paragraph in the Key Policy Judgements chapter also noted that while projecting an easing cycle, *“interest rates are likely to remain well above neutral for some time”*.

The bottom line is that monetary policy is going to take on pygmy-type qualities over the coming year: nothing stands tall, nor looks very attractive. Such is the reality of coping with "a challenging environment of weak activity and high inflation", as noted by the Governor.

RBNZ 90-day bank bill projections



Sources: ANZ National, RBNZ

At this stage, we are pencilling in a series of steady 25bp cuts starting from September, taking the OCR towards the neutral zone of around 6 to 6.5 percent by the end of 2009. However, the RBNZ's wariness over elevated inflation expectations, and their concerns over the impact of an unorderly currency adjustment,

means that we could be in for a staggered and elongated easing cycle. This would take the form of three or four rate cuts, followed by a pause, then the start of another mini easing cycle. Looking at how central banks overseas have responded over the past year to the global credit crisis, we have some sympathy for the Bank of England approach of cutting and pausing, before cutting again. It is, after all, overall financial conditions that are important as opposed to the OCR itself. While a staggered easing cycle will prevent the currency from falling too far too fast, it also means that growth will underperform for a period of time.

Financial Market Implications

This was a statement for the doves. The currency fell a cent against the Greenback, and rates rallied strongly across the board. The market is now fully priced for a September rate cut, with over 140bps of cuts priced in over the next twelve months. The currency is expected to remain heavy and the bias in rates firmly on the receive side as the focus turns to the dataflow.

We continue to expect the data to show further economic weakness. In this environment, the trend in rates and the NZD will remain the markets' friend.

June MPS Projections (March 2008 MPS Projections in brackets)

Half year average	H1 2008	H2 2008	H1 2009	H2 2009	H1 2010
90 day	8.8 (8.8)	8.5 (8.8)	8.1 (8.7)	7.8 (8.5)	7.3 (8.0)
TWI	71.0 (72.3)	67.8 (71.6)	65.9 (71.4)	64.5 (71.0)	62.9 (69.9)
March years	2008	2009	2010	2011	
CPI (ann % chg)	3.4 (3.4)	4.4 (3.0)	3.0 (2.7)	2.6 (2.6)	
GDP (ann ave % chg)	3.1 (3.0)	0.9 (1.9)	1.4 (1.9)	2.5 (2.0)	

Text of the policy assessment

The Official Cash Rate (OCR) remains unchanged at 8.25 percent.

Reserve Bank Governor Alan Bollard said: "The global economy is currently experiencing significant increases in oil and food prices. These price increases are occurring at the same time as activity is weakening in many economies in response to the global credit crisis and slowing housing markets. In New Zealand, this confluence of factors is producing a challenging environment of weak activity and high inflation.

"We project annual CPI inflation to peak at 4.7 percent in the September quarter of this year. Although much of this reflects higher food and energy prices, underlying inflation pressure also remains persistent. Nevertheless, we do still expect inflation to return comfortably inside the target band over the medium term. This is based on the expectation that commodity prices stop rising, inflation expectations remain anchored, and weakening economic activity contributes to an easing in non-tradable inflation.

"The outlook for economic activity is now weaker than in our previous Statement. We project little GDP growth over 2008, and only a modest recovery thereafter, largely reflecting a weaker household sector. Government spending and personal tax cuts will provide some offset to this lower growth but will also add to medium-term inflation pressure.

Consistent with the Policy Targets Agreement, the Bank's focus will remain on medium-term inflation. Provided the economy evolves in line with our projection, we are now likely to be in a position to lower the OCR later this year, which is sooner than previously envisaged."

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