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## RESERVE BANK JUNE MONETARY POLICY STATEMENT

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### Key points

- **The Reserve Bank increased the OCR by 25 basis points to 8.0 percent.**
- **The hike is aimed at making sure the job is done.**
- **There is a material risk of a further move in July. The Reserve Bank has little inflation headroom to absorb continued upside data surprises.**
- **We ascribe a 35 percent chance of a further hike.**
- **The end game for this economy is slower growth and a turn in the currency. We suspect this is not far off.**

### Key phrases

- **The Reserve Bank notes domestic activity has accelerated since late 2006.** *“Housing market activity has been buoyant, consumer confidence has remained relatively robust and a range of business sector indicators, including employment and investment intentions have been strong.”*
- **But this has led to further capacity constraints, which continue to place pressure on inflation.** *“Following several years of strong growth, firms have indicated that capacity remains stretched and that finding both skilled and unskilled staff has become increasingly difficult. These pressures continue to underpin inflation”.*
- **The Reserve Bank acknowledged early signs of softening economic activity, but admit it is too early to be confident this will continue.** *“There are some early indications from recent opinion surveys and other data that growth may be starting to soften, but these are by no means conclusive. Indeed, at present the risks to domestic activity appear to remain on the upside.”*
- **Dairy prices were singled out as a cause for concern.** *“A significant development in the past six months has been a marked increase in dairy prices. ...The rise in dairy sector incomes will provide a substantial boost to economic activity over the next few years, but will also add to inflation pressures.”*
- **The comments from the April Review about the high NZD were repeated.** *“As we noted in April, the exchange rate is at levels that are both exceptionally high and unjustified on the basis of New Zealand’s medium-term fundamentals”.*
- **The OCR increase is seen as a means to ensure inflation stays within the target band.** *“Had we not increased the OCR this year, it is likely that the inflation outlook would now be looking uncomfortably high. This further increase in the OCR is to ensure that inflation outcomes remain consistent with achieving the target of 1 to 3 percent inflation on average over the medium term.”*

### Assessment

**Today’s hike was designed to get the job done.** As we had expected, today’s 25bps increase in the OCR to 8.00 percent was to make sure that the Reserve Bank’s desired slowdown in domestic demand does eventuate. Though the Reserve Bank acknowledges that there are early signs of softening, they admit that it is too early to be confident that this will continue. The Reserve Bank continues to expect recent increases in lending rates to eventually act to slow activity over the second half of this year. However, given the sizeable boost to New Zealand’s terms of trade from higher world dairy prices, the Reserve Bank is faced with more medium-term pressure on resources and inflation.

**The overall nuances are very hawkish.** While the Reserve Bank, as in April, did not provide any guidance on future policy moves, the risk to interest rates is clearly pointed one way (despite nuances from the Governor in an interview that he hoped he did not have to hike again):

- The Reserve Bank still expects CPI inflation to remain at the top of the policy target band through 2008, 2009 and 2010. There is zero inflation headroom. In fact, the medium-term outlook for inflation has deteriorated relative to the March *Statement*, despite interest rates and the NZD being materially higher.

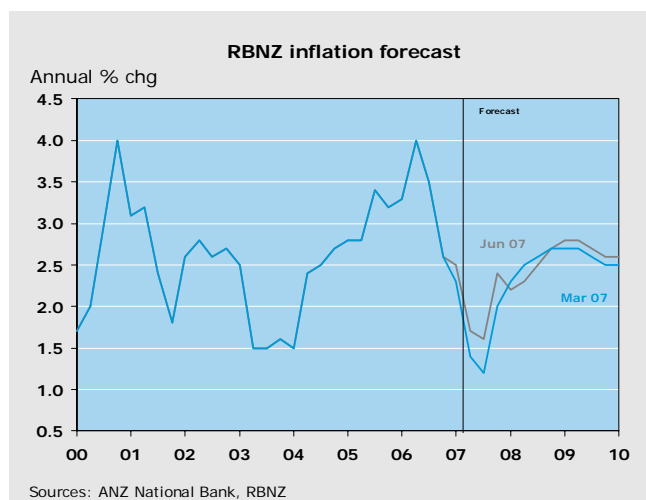
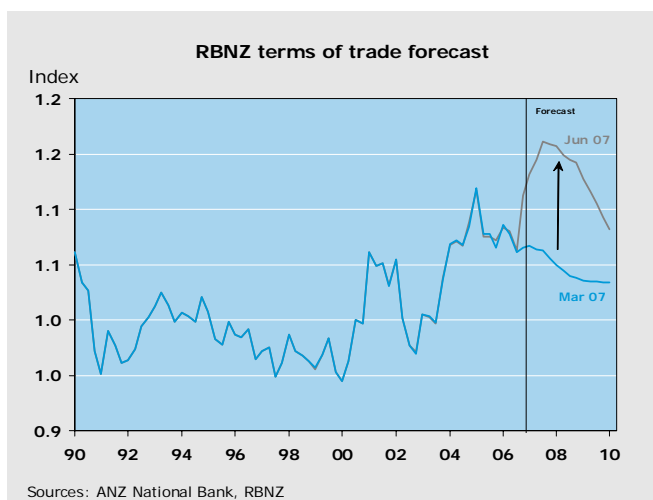
- Overall, despite interest rates projected to stay higher for longer and some signs that growth may be starting to soften, the Reserve Bank continues to see the balance of risks to the medium-term inflation outlook as to the upside.
- An alternative interest rate scenario, which is based on further lifts in commodity prices and a more stretched economy, portrays a 90-day track hitting 8.5 percent. This is implicitly signalling a further hike if the terms of trade continue to surprise to the upside.
- There looks to be clear upside risk to some key bellwether releases, namely Q1 GDP and Q2 non-tradable inflation (with the Reserve Bank pencilling in 0.8 and 0.9 percent respectively) before the July OCR *Review*.

**The boost to the terms of trade is keeping the Reserve Bank on alert.** Today's *Monetary Policy Statement* devoted a considerable amount of space to the sharp increase in world dairy prices, and what that would mean to the growth and inflation outlook. The Reserve Bank expects dairy prices to stay high at current levels for at least another year or so, before trending lower in 18 months time. Relative to their March *Statement*, the Reserve Bank has revised their terms of trade projections up by 10 percent. But even with the increase in the OCR to 8.00 percent, the Reserve Bank still does not expect it to fully offset the increased inflation pressure from a higher terms of trade.

**While the Reserve Bank is conscious of the risks of over-tightening late in the cycle, they are also aware of the need contain domestic demand.** The Reserve Bank needs to ensure that there is a sustained period of slower growth in domestic activity. Interest rates are now projected to stay higher for longer to ensure that they get this slowdown.

**The Reserve Bank is critically assuming they can get on top of the housing market.** The housing market is expected to ease, with price gains receding back to zero. While this accords with our own view (and we are very mindful of the extent of leverage within the housing sector), the Reserve Bank is nonetheless facing headwinds emanating from restricted supply, globalisation, and ample liquidity. They will remain mindful of the resilience that has been shown in the past.

**Despite mention of the currency being exceptionally high and unjustified, the Reserve Bank does not appear close to intervening.** When asked about the possibility of intervention in the press conference, this was downplayed by the Governor.



## Financial market implications

**There remains a key risk of a further hike in our view.** Key data to watch going forward are partial indicators for Q2, notably domestic demand measures including housing and retail activity. We expect to see signs of moderation in line with that indicated by confidence gauges. But such a softening may not in fact deter the temptation to deliver a further move given the lack of inflation headroom, and pending stimulus in the form of the dairy payout and fiscal policy. We remain very wary of an upside surprise to Q2 non-tradable inflation, due on 16 July.

**The Reserve Bank will get their desired sustained slowdown in domestic demand.** While higher interest rates will continue to provide support to the NZD in the near term, the end game here is slower growth. Ironically, such an outcome adds to the case for an aggressive turn in the currency. We still favour such a currency move before the end of the year.

**We are becoming increasingly nervous about how this economic cycle will unfold.** The housing market is clearly under the gun, and facing a huge jump in fixed lending rates. The export sector is being hollowed out by the high currency. There are numerous positives supporting growth such as dairy prices, fiscal policy and infrastructure spending. But the additional impetus from such areas will merely intensify the adjustment necessary via the housing market. Softer growth will turn the currency, which will immediately add to headline inflation pressure. Unlike previous cycles, the tradable sector does not have excess capacity at present, implying that a pick-up in that sector in response to a softer currency will also add to inflation pressures. It feels like the New Zealand economy could be headed for a vicious circle of weaker growth, an adjustment in the currency, higher inflation, central bank unease or inability to act as a stabiliser, weaker growth... and the spiral is in motion. The only way to ensure the spiral does not become problematic is via an aggressive adjustment in the housing market to cap non-tradable inflation. Curbing inflation – and the Reserve Bank’s forecast portray a huge pipeline of pressure – is not growth friendly. Indeed the Reserve Bank and most forecasters are assuming the fabled soft landing. We struggle to see inflation coming down in such an environment.

### RBNZ June MPS Projections

RBNZ Projections for June MPS (March MPS Projections)					
Half year average	H1 2007	H2 2007	H1 2008	H2 2008	H1 2009
90 day	7.9 (7.8)	8.3 (7.9)	8.3 (7.9)	8.2 (7.7)	7.9 (7.4)
TWI	70.2 (68.6)	72.0 (68.3)	71.6 (67.3)	70.7 (65.8)	69.5 (64.7)
March years	2007	2008	2009	2010	
CPI (ann % chg)	2.5 (2.3)	2.2 (2.3)	2.8 (2.7)	2.6 (2.5)	
GDP (ann ave % chg)	1.7 (1.8)	3.1 (3.1)	2.8 (2.4)	2.0 (2.1)	

### Reserve Bank’s Policy Assessment

*The Official Cash Rate (OCR) will increase by 25 basis points to 8.00 percent.*

*Domestic demand has grown strongly since late 2006, particularly in the household sector. Housing market activity has been buoyant, consumer confidence has remained relatively robust and a range of business sector indicators, including employment and investment intentions, have been strong. As we have noted recently, government spending continues to increase, which is contributing to domestic demand.*

*Following several years of strong growth, firms have indicated that capacity remains stretched and that finding both skilled and unskilled staff has become increasingly difficult. These pressures continue to underpin inflation.*

*A sustained period of slower growth in domestic activity will be required to alleviate inflation pressures. Lending rates have risen significantly in recent months, partly due to previous increases in the OCR. Given the usual lags, we have not yet seen the effect of these increases on domestic demand and inflation pressures. There are some early indications from recent opinion surveys and other data that growth may be starting to soften, but these are by no means conclusive. Indeed, at present the risks to domestic activity appear to remain on the upside.*

*A significant development in the past six months has been a marked increase in dairy prices. While there are uncertainties about the future path of these prices, the increases will assist in narrowing New Zealand’s trade deficit. The rise in dairy sector incomes will provide a substantial boost to economic activity over the next few years, but will also add to inflation pressures.*

*Parts of the export sector outside the dairy industry will continue to face challenging conditions due partly to the New Zealand dollar. As we noted in April, the exchange rate is at levels that are both exceptionally high and unjustified on the basis of New Zealand’s medium-term fundamentals.*

*Had we not increased the OCR this year, it is likely that the inflation outlook would now be looking uncomfortably high. This further increase in the OCR is to ensure 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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