NEW ZEALAND ECONOMICS
RBNZ OCR REVIEW

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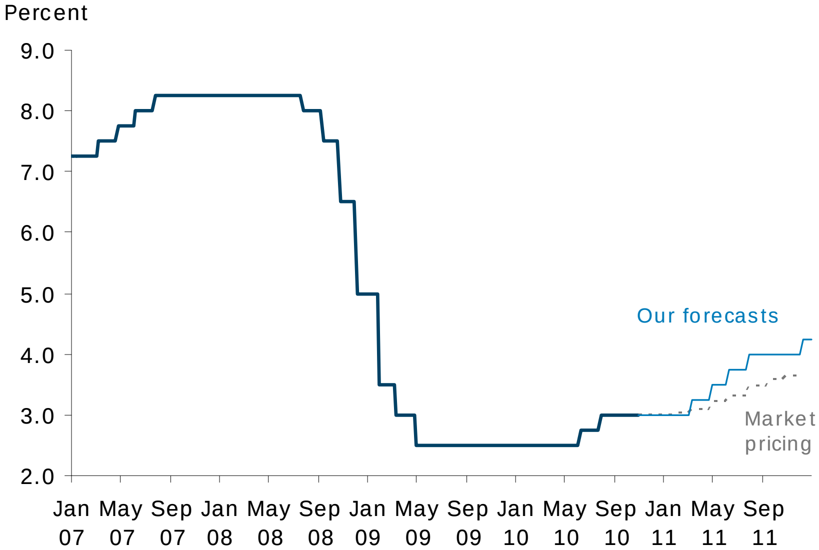
RBNZ DELIVERS NO SURPRISES

KEY POINTS

- The RBNZ left the OCR unchanged at 3 percent, as widely expected.
- The policy assessment, which was a tad more downbeat than the September assessment, contained no major surprises.
- The broad spirit of the RBNZ's September *Monetary Policy Statement* remains.
- With domestic demand remaining subdued, there is no urgency on the part of the RBNZ to lift the OCR yet, though the Bank noted that "further removal of monetary policy support will be required at some stage."
- We expect the RBNZ to leave the OCR unchanged until March 2011, with the removal of policy stimulus to be staggered and drawn out, resulting in a lower end point compared to previous cycles.
- Our forecast for the OCR track is more aggressive than current market pricing but still with a lower end game relative to history.

RBNZ Official Cash Rate



Sources: ANZ, National Bank, Bloomberg

DATA REVIEW

COMMENT AND ASSESSMENT

The no change decision by the RBNZ was widely expected, and the accompanying policy assessment delivered no surprises. The domestic dataflow has been slightly weaker than the RBNZ's projections, and downside risks to the global growth outlook remain. The RBNZ noted that "it is unclear how further policy support would impact on the outlook for growth in our Western trading partners", a likely reference to the further round of quantitative easing (QE2) that the US Federal Reserve is expected to embark on next week.

However, as the RBNZ made clear, there are also pockets of strength, such as strong growth in China, Australia and emerging Asia, and high prices for NZ's major export commodities. Earthquake reconstruction activity in Canterbury was also cited as lending support to activity over the coming year, though we have to bear in mind the negative balance sheet impact from the earthquake destruction.

Overall, the broad spirit of the RBNZ's September *Monetary Policy Statement* remains intact. Specifically:

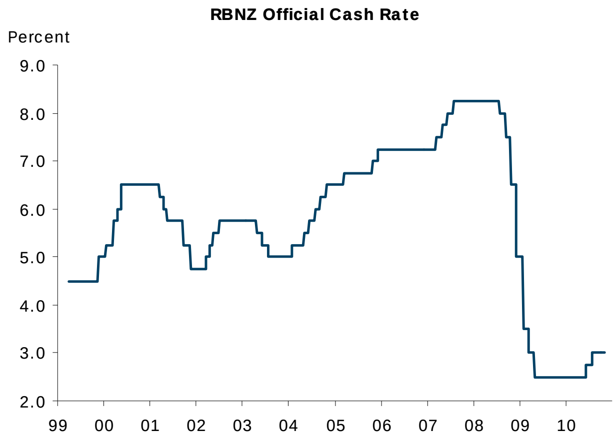
- current momentum in the economy is subdued;
- the outlook is better going forward;
- they still see limited prospects for the one-off rise in inflation (from the GST increase) to impact on medium-term inflation expectations; and
- interest rates will still likely have to move up "at some stage".

At the margin we can see a slightly softer tone in today's assessment. The economic data since September has been "weaker than projected", though it still fits within the spirit of their September forecasts. Sentiment towards the global economy has shifted from "slowing" in September to "downside risks". In addition, the RBNZ now thinks growth is expected to only "gradually" absorb current surplus capacity over the next few years, as opposed to "progressively". But beyond such semantics, the real message appears to be one of business as usual and waiting patiently on the sidelines.

We continue to expect the next move in the OCR to be up, starting from March 2011. We believe the loss of momentum in the economy over Q2 and Q3 is nearing its end, and signs of a pick-up will start to become evident. The RBNZ made reference to firms becoming less optimistic about their future prospects, whereas yesterday's National Bank *Business Outlook* survey showed a rise in the own activity reading. This may well signal a turning point in this regard. We also take comfort from supportive financial conditions, and high commodity prices leading to a record-high terms of trade, which will eventually filter through the economy. We are not saying that the economy is set to boom, rather simply that conditions for improvement are in place. Underlying inflation (excluding government policy changes such as GST increases) has bottomed, and will start to rise, though we expect it to be contained within the target band.

But for now the RBNZ clearly has time on its side to wait and assess developments.

The tightening cycle we are looking for next year will be staggered, and the end point for the OCR will be lower compared to past cycles. This partly reflects the positively shaped yield curve and the higher proportion of borrowers on floating and shorter-dated fixed rates, giving the OCR lever more potency. We expect the OCR to reach 4.25 percent by the end of 2011, and rise towards 5.25 percent over 2012. This is modest by historical standards, but more aggressive than current market pricing.



Sources: ANZ, National Bank, RBNZ

DATA REVIEW

FULL RBNZ PRESS RELEASE

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

Reserve Bank Governor Alan Bollard said: “Despite some data turning out weaker than projected, the medium-term outlook for the New Zealand economy remains broadly in line with that assumed at the time of the September *Monetary Policy Statement*.

“Downside risks to the outlook for global growth continue, with high public and private debt inhibiting recovery in many developed economies. Moreover, it is unclear how further policy support would impact on the outlook for growth in our Western trading partners. Offsetting this weakness, strong growth continues in China, Australia and emerging Asia.

“Domestically, recent data has turned out weaker than projected. Continued household caution has seen consumer spending and housing market activity remain muted, and many firms have become less optimistic about their future prospects. However, continued high export prices, along with reconstruction and repairs in Canterbury, will support activity over the coming year.

“Overall, continued GDP growth is expected to gradually absorb current surplus capacity over the next few years. Headline inflation is expected to move higher following the recent increase in the rate of GST. The subdued state of domestic demand suggests this inflation spike will have limited impact on medium-term inflation expectations.

“While it is appropriate to keep the OCR on hold today, it remains likely that further removal of monetary policy support will be required at some stage.”

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