

### RBNZ March *Monetary Policy Statement* Review

#### Key points

- > The OCR was left unchanged at 8.25 percent as widely expected.
- > The tenor was more hawkish than expected (although consistent with a neutral bias), a testament to the lack of inflation headroom the RBNZ faces despite downside growth risks.
- > The RBNZ remains watchful, but in the meantime expects the OCR to remain at current levels for a significant time.
- > In the current elevated inflationary environment, the hurdle to a rate cut is high and requires a substantial deterioration in the growth outlook.
- > We remain more inclined towards rate cuts at the end of 2008 based on our view that momentum is decelerating more sharply than assumed in the RBNZ's projections.

#### Assessment

The RBNZ's no change decision was not a surprise but the tone was perhaps more hawkish than we had expected, although still consistent with a wait-and-see approach and neutral bias.

We and the market generally were looking for a potential soft underbelly to today's statement, which was not forthcoming. The underlying message remains one of wariness towards inflation pressure that has implicitly tied the RBNZ's hands. But across the dove-hawk spectrum, there looked to be something for everyone.

It was always going to be a tough balancing act between upside inflation risks against downside growth risks. The former is mostly known; coming from a tight labour market, more government spending (including tax cuts) and the Government's planned emissions trading scheme (ETS). The latter is very uncertain at this stage, and highly dependent on the evolving global economic, financial and credit markets outlook, the extent of the housing market slowdown, dry weather conditions and tightening credit conditions domestically. Moreover, the distribution between the two is asymmetrical, with the RBNZ noting modest upside inflation risks as being a higher probability, but downside growth risks being of lesser probability, but potentially severe. **As such the Statement contains much discussion on risks, which highlights the uncertainty surrounding the outlook.**

#### In terms of the projections:

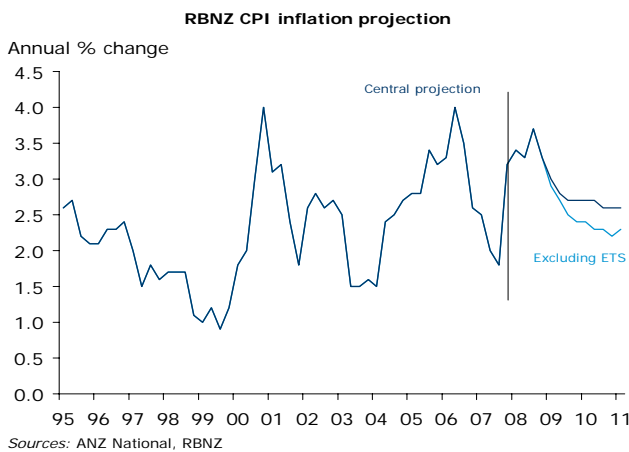
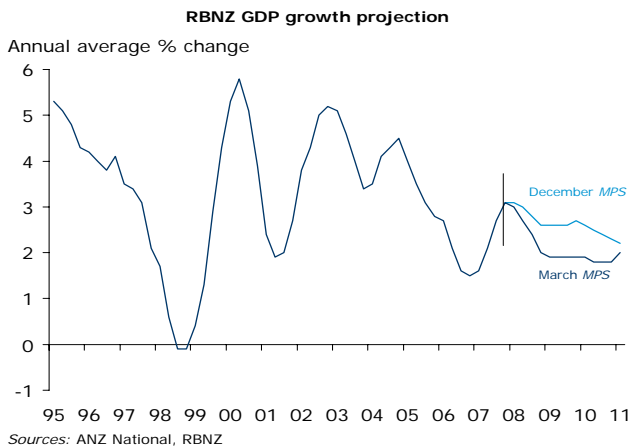
- **Growth was revised significantly lower.** The RBNZ now expects GDP growth to average just 2 percent over the next 3 years, and still sees downside risks to this.
- **Inflation is higher.** Their CPI projections are higher compared to their December *MPS*, but this is mainly due to the inclusion of the ETS, which the RBNZ has explicitly incorporated into their

projections and policy deliberations for the first time. The RBNZ estimates that the ETS will add around ½ percentage points to CPI inflation by 2010. **If the ETS effect was removed, underlying inflation would have been lower than their December projections (and so too will their 90-day projections).**

- **The 90-day track is broadly similar to December's**, remaining at 8.8 percent until mid-2009 before declining towards 7 percent by 2011.
- **The RBNZ now expects house prices to fall by 4 percent this year**, which is looking likely to be light given the speed with which the housing market is adjusting and the headwinds it is facing.
- **The RBNZ's view on trading partner growth is based on February's Consensus forecasts**, which is likely to be revised further downwards over the coming months in light of the deteriorating outlook for the US economy.

**The RBNZ is showing resolve in the face of uncertainty.** While there is little talk in the *Statement* of the need for higher rates, the bottom line is that the RBNZ appears very mindful of the potential for the market to front-run an easing cycle and loosen monetary conditions at a time inflation pressures remain worrying. As we noted in our preview, fresh in the RBNZ's mind is the experience over late 2005 and early 2006 when slower growth failed to ease inflation pressure. In the current environment where the slowdown in growth is still based on partial data and anecdotes, as opposed to concrete data, the RBNZ will want to see softness in growth in the hard data before shifting to an easing bias. In addition, there is an overwhelming persistence about the number of one offs for inflation (emissions trading, food, oil, energy) that mean the demand side of the economy needs to bear a greater

adjustment to dampen aggregate inflation pressure. In the meantime it's a case of going with what you know, which at present is inflation pressure.



**The key message from today's Statement is that the RBNZ's hands are tied given the elevated inflation reading.** The lack of inflation headroom means that at this stage at least, the RBNZ does not view cutting the OCR as an insurance against downside growth risks as an option – in fact the statement is explicit on the fact: *“We do not believe it is appropriate to lower rates as insurance against growth risks given elevated inflation.”* The RBNZ expects the OCR to remain at current levels for a "significant" time yet, with the 90-day projections largely unchanged from December's. By 2009 a

substantially negative output gap opens up in their projections but inflation remains somewhat sticky, testament to the powerful influence food and emissions related inflation are having.

**The bottom line is that the hurdle to a rate cut is high, and requires a substantial deterioration in the growth outlook.** For now, The RBNZ remains in wait-and-see mode, assessing the global situation and incoming data. By frontloading all the known inflation risks into their projections, as they have done with the ETS, the RBNZ is effectively giving themselves some potential breathing space.

**We remain more inclined towards rate cuts at the end of 2008.** We foresee growth closer to 1 percent in 2008, and anecdotes point to momentum stalling in H1. We expect recent tightening in financial conditions via the credit channel to be a significant influence on growth prospects via retail mortgage rates, and ultimately require less restrictive wholesale rates to counter. Indeed, we suspect economic data will soon take on a consistently negative tone as Q1 figures are released.

**Financial Market Implications**

**With little for the doves, the NZD/USD increased around 60 pips while the swaps curve sold off by 2 bps.** However, the NZD move was partly capped by comments from RBNZ Governor Alan Bollard describing the dollar as exceptionally and unjustifiably high during the press conference, words last used prior to the RBNZ intervening in the currency market. Given the aggressive sell-off in the Australian curve, the relatively muted reaction across the NZ swaps curve suggest the market remains attuned to both the RBNZ's inflation unease, but also mindful of how developments could unfold in a sharp manner.

**Going forward, it is back to watching the dataflow.** We continue to expect the data to show further signs of softening domestic demand, but it may well be how the global environment plays out and particularly the path for commodity prices that will hold the key to an earlier easing cycle.

| March MPS Projections (December 2007 MPS Projections in brackets) |             |             |             |             |             |
|---|-------------|-------------|-------------|-------------|-------------|
| Half year average   | H1 2008     | H2 2008     | H1 2009     | H2 2009     | H1 2010     |
| 90 day  | 8.8 (8.8)   | 8.8 (8.7)   | 8.7 (8.7)   | 8.5 (8.4)   | 8.0 (7.9)   |
| TWI   | 72.3 (70.5) | 71.6 (70.6) | 71.4 (70.5) | 71.0 (70.0) | 69.9 (69.4) |
| March years   | 2007        | 2008        | 2009        | 2010        | 2011        |
| CPI (ann % chg)   | 2.5 (2.5)   | 3.4 (3.2)   | 3.0 (3.0)   | 2.7 (2.5)   | 2.6 (2.3)   |
| GDP (ann ave % chg)   | 1.6 (1.7)   | 3.0 (3.1)   | 1.9 (2.6)   | 1.9 (2.6)   | 2.0 (2.2)   |

## Text of the policy assessment

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

Reserve Bank Governor Alan Bollard said: "The outlook for economic activity has deteriorated somewhat since we reviewed the OCR in January. The main reasons are weaker prospects for world growth, tighter credit conditions, a sharper-than-expected slowing in the housing market, and recent dry weather conditions. On balance, we now expect GDP growth of around 2 percent over the next three years.

"Despite the weaker outlook for activity, we expect headline inflation to remain high, partly due to the inclusion of the planned emissions trading scheme in our projection. Higher food and energy prices are also contributing to near-term inflation. Furthermore, over the medium term, a tight labour market, strength in commodity prices, and the impact of announced government spending plans and assumed personal tax cuts will add to inflationary pressure. Excluding the effects of the emissions trading scheme, inflation is projected to return close to the mid-point of the target band by 2010.

"There is more uncertainty than usual at present, with downside risks to activity and upside risks to inflation. The main downside risks are a further deterioration in the world economy, tighter credit conditions, and the potential for a more severe downturn in the housing market. Conversely, further strength in labour costs, additional fiscal stimulus, and high inflation expectations represent key upside risks to underlying inflation.

"Given this outlook, we expect that the OCR will need to remain at current levels for a significant time yet to ensure inflation outcomes of 1 to 3 percent on average over the medium term."

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ANZ, Level 7, 1 Victoria Street, Wellington 6011, New Zealand Phone 64-4-802 2000 Fax 64-4-496 8639  
<http://www.anz.com/nz> e-mail [ecnmcs@anz.com](mailto:ecnmcs@anz.com)