

NEW ZEALAND ECONOMICS RBNZ JANUARY OCR REVIEW

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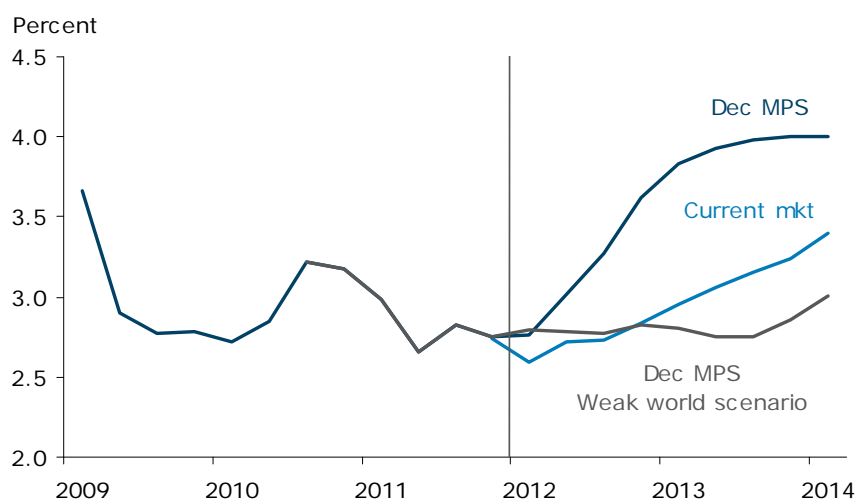
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RBNZ ON HOLD, AND CONTINUES TO KICK FOR TOUCH

KEY POINTS

- The RBNZ left the OCR unchanged at 2.5 percent, the decision was widely expected.
- The policy statement was concise and to the point, but mildly softer compared to December.
- The RBNZ stuck with the same ending paragraph as the one used in the December MPS, but omitted the words "for now". This is as close to a neutral stance as one could have expected.
- The RBNZ have made explicit mention of global growth risks, rising funding costs, the strong NZD, and potential delays of the rebuilding of Christchurch. A high degree of comfort over the inflation outlook, combined with a weaker activity outlook, have provided them with considerable scope to stay on the sidelines.
- We do not see a RBNZ hike until December at the earliest.

Published MPS 90-day interest rate tracks and bank bill futures



Sources: ANZ, National Bank, RBNZ

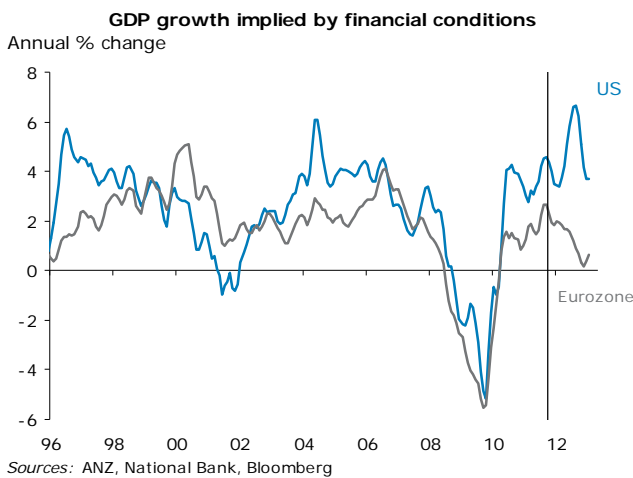
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COMMENT AND ASSESSMENT

Today's OCR decision and assessment did not contain much by way of surprises. The RBNZ's no-change decision was widely expected. The statement was concise and to the point.

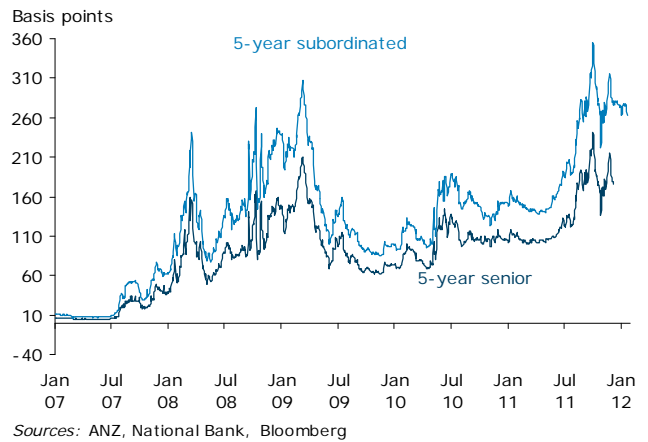
The tone of the statement was similar to the December MPS. But in the key final sentence they say "it remains prudent to keep the OCR on hold at 2.5 percent" – dropping "for now". On the face of it this is more neutral and dovish, though we presume the RBNZ's core interest rate projections have not changed too much from December (a slow grind higher over time), indicating a heavily watered down tightening bias remains in the background.

Global events continue to drive the RBNZ's view. The policy assessment reaffirmed that the global outlook is poor, despite an improvement in financial market sentiment. The RBNZ stressed again that the risks are skewed to the downside. Our financial conditions indices point to a slowing in global growth momentum, which will eventually weigh on New Zealand economic activity.



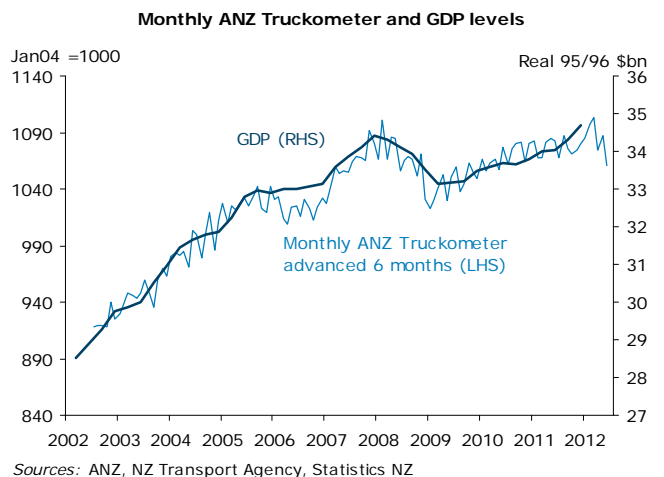
The Reserve Bank is also still keeping a close eye on funding costs, with the policy assessment noting that the European debt crisis has increased the cost of international funding. Elevated CDS spreads for the big 4 Australian Banks and upward movements in retail deposit rates suggest these pressures remain acute. Our Financial Conditions Index suggests elevated funding costs are knocking about 1 percent off annual growth in New Zealand. We are closely watching deposit rates. If competition escalates and rates to start to rise, the case for an OCR cut will strengthen.

CDS spreads for "Big four" Australian Banks



The high NZD remains a concern. Export commodity prices remain elevated and a key source of economic support. However, the statement noted that the recent rise of the NZD is reducing exporters' returns, and by implication the rebalancing of the recovery. However, in the current circumstances, the ability of the RBNZ to drive the dollar lower is limited.

The RBNZ sees "modest growth" in the domestic economy, with "signs of a limited recovery in household spending and the housing market". We concur and don't see this changing soon. Given high debt levels, the process of ongoing deleveraging has further to run. This is likely to temper the current recovery in the housing market and the flow-through into consumer spending and inflationary pressure.



In fact an even softer period of growth beckons in H1 2012. Our proprietary gauges indicate a possible stalling in economic momentum over the first half of this year, given the combined headwinds posed by a weaker world outlook, a post-Rugby World Cup hangover, and the need to cut domestic stock levels. A weaker starting point for economic

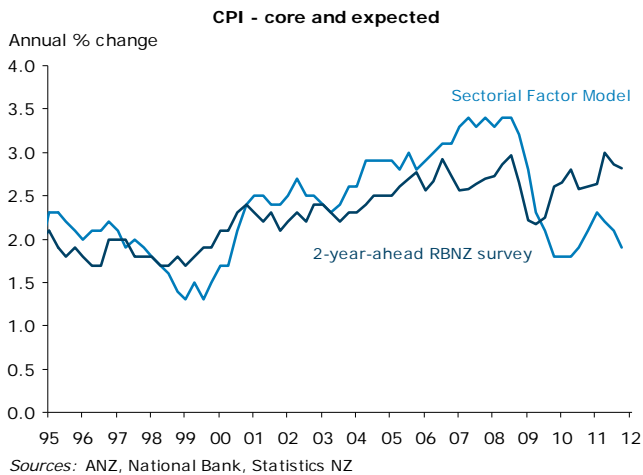


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activity reduces pressures on capacity and hence inflationary pressure, providing the Bank with more scope to sit on the sidelines.

The RBNZ continues to await inflation pressures arising from earthquake reconstruction, but notes that aftershocks may cause further delays. We note that the Governor is speaking on the record tomorrow in Christchurch in regard to navigating multiple crises, which may help shed some light on the RBNZ's current thinking on the rebuild and its inflationary consequences.

Dormant inflation pressures give the RBNZ scope to play a patient game, with the Bank noting that inflation pressures have remained "well contained". This suggests a greater degree of comfort than seemed apparent in the December *MPS*. It seems some of the downward inflation surprises of the last two *MPS* forecasts are now being interpreted as "news". The statement did not comment on inflation expectations, suggesting a greater degree of comfort that medium-term drivers remain consistent with the target.



While the RBNZ statement shows a greater willingness to remain on hold for longer, we think a slight tightening bias remains. At 2.5 percent the OCR is very low, notwithstanding the impact of higher funding costs on retail borrowing rates – especially since it isn't all one-way traffic, with the economy the beneficiary of a once in a generation terms of trade boom, and with the pending inflationary impact of earthquake reconstruction.

The upshot is that with large downside global risks still present, with a more moderate activity outlook, more inflation headroom, and with continuing uncertainty over the pace of earthquake reconstruction, there is no hurry to move the OCR higher. The RBNZ are not alone in

wishing to maintain accommodative policy settings. This morning's FOMC statement signalled an intention to maintain the exceptionally low Fed Funds rate for longer than previously signalled (at least through late 2014). This will complicate the situation for the RBNZ further as the Fed has effectively given a green light to a weaker USD (and by implication a stronger NZD). There is nothing the RBNZ can do about the global situation but watch, worry and wait.

JANUARY OCR REVIEW PRESS RELEASE

OCR unchanged at 2.5 percent

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.

Reserve Bank Governor Alan Bollard said: "Since the time of the December Statement, financial market sentiment has improved slightly, with increased liquidity in European financial markets. However, the global economy remains fragile and risks to the outlook remain.

"World prices for New Zealand's export commodities have remained elevated but the recent appreciation of the New Zealand dollar is reducing exporters' returns. The European debt crisis has also increased the cost of international funding, which will likely pressure funding costs for New Zealand banks over the coming year.

"In the domestic economy we continue to see modest growth. Over recent months there have been signs of a limited recovery in household spending and the housing market. Further ahead, repairs and reconstruction in Canterbury will also provide a significant boost for an extended period, though there may be further delays resulting from the aftershocks.

"Reassuringly, inflation pressures have remained well contained. Inflation has declined and now sits below 2 percent.

"Given ongoing uncertainty around global conditions and the moderate pace of domestic demand, it remains prudent to keep the OCR on hold at 2.5 percent."

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