

## NEW ZEALAND ECONOMICS RBNZ JULY OCR REVIEW

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### RBNZ READY TO REMOVE INSURANCE CUT. WE ARE NOW CALLING FOR 50BP HIKE IN SEPTEMBER

#### KEY POINTS

- The RBNZ left the OCR unchanged at 2.5 percent, but made it clear that the March insurance cut will be removed soon, though subject to some global caveats.
- We now see the RBNZ taking out the insurance cut at the next meeting, and are calling a 50bp hike in September. We see no point in unwinding the insurance cut in multiple steps.
- But we think the RBNZ will pause thereafter to assess the landscape. The Governor made it clear that the high NZD is a concern, which will lessen the need for *further* increases thereafter.
- The bottom line is that the OCR is set to move off emergency settings but still remain stimulatory.

#### RBNZ OCR PRESS RELEASE

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

Reserve Bank Governor Alan Bollard said: "The economy has grown more strongly than was expected, and it appears that the recovery is getting back on track, supported by a strong terms of trade. At the same time, however, current fragility in global financial markets, including the uncertainty around the US Government's debt ceiling, continues to highlight the downside risk to trading partner activity noted in the June Statement.

"Annual headline CPI inflation continues to be above the Bank's 1 to 3 percent target band. However, much of the current spike in inflation has been driven by the October 2010 increase in the rate of GST, and will therefore be temporary. Wage and price setters should focus on underlying inflation, which is currently estimated to be below 2.5 percent.

"Provided current global financial risks recede and the economy continues to recover, the Bank sees little need for the March 2011 'insurance' cut to remain in place much longer. The current very high value of the New Zealand dollar is acting as a drag on the New Zealand economy. If this persists, it is likely to reduce the need for further OCR increases in the short term."

## DATA REVIEW

**COMMENT AND ASSESSMENT****Today's RBNZ statement accompanying their no change decision has to be one of their shortest.**

But in our view, it is possibly their best statement that we have seen in a long while. It was direct and to the point.

**The key message is that the 50bp insurance cut is not needed much longer.** The wording is clear: "Provided current global financial risks recede and the economy continues to recover, the Bank sees little need for the March 2011 'insurance' cut to remain in place much longer." While the global scene is a clear caveat, our baseline forecast assumes current nervousness settles down, though within the spirit of a long drawn out recovery process for Western economies.

**We expect a 50bp hike in September.** We see little point removing the insurance cut in multiple steps. Best to get it out in one go when it is clear that it is no longer needed. We note that in March when the RBNZ cut rates, they noted that "The Bank can ease policy knowing that the resultant reduction in effective interest rates (due to a high proportion of people on floating rates and the slope of the yield curve) can be reversed quite quickly once the economy begins to recover." There is also the issue of showing that the RBNZ is not asymmetric when it comes to providing, and then removing, insurance moves.

**Beyond September, we think the RBNZ will pause and assess the landscape.** A further move before the end of the year is certainly possible, and will very much be subject to how the recovery progresses. But by moving earlier and by more, it gives the RBNZ space to be more considered later on.

**The high flying NZD is clearly a key factor in the RBNZ's policy deliberations.** As the Governor noted, it is "acting as a drag on the New Zealand economy. If this persists, it is likely to reduce the need for further OCR increases in the short term." Some appear to be reading this as potentially displacing the need for the removal of the insurance cut. We beg to differ, for it makes reference to the currency reducing the need for further increases (i.e. after the insurance cut has been removed). In short, the NZD will be influential in how fast and far this tightening cycle goes beyond the reversal of the insurance cut. We expect a gradual lift in the OCR over 2011/12 in a stop start manner, something akin

to how the RBA operates. We see the OCR at around 4 percent by the end of 2012.

Turning to the contents of the statement, **the RBNZ acknowledged a stronger domestic economy**, which is fairly obvious given the recent run of strong local data. Tellingly perhaps, the words "Christchurch" and "earthquake" were absent in the statement, a clear sign that the economic recovery no longer hinges on the earthquake rebuild. The uncertain global backdrop is also acknowledged, with risks to the downside for trading partner growth prospects.

**Inflation nuances are muted with the jump in the headline rate expected to be temporary. We concur with this.** The RBNZ has noted that "wage and price setters should focus on underlying inflation, which is currently estimated to be below 2.5 percent." This is obviously directed at preventing the high headline inflation rate from seeping into rising inflation expectations. But the choice of "below 2.5 percent" is somewhat telling. The last time we looked, the middle of the policy target band was 2 percent. Is the RBNZ now ratifying wage and price setting behaviour above the middle of the band? We don't think so, but this in itself tells us that getting core inflation to the middle of the band is going to be a challenge. Food for thought.

**IMPLICATIONS**

**The RBNZ should be stoked with the market reaction this morning.** The NZD rose slightly and the rates market has moved to price in around a 70 percent chance of a 50bp hike in September, but longer term yields have fallen as the amount of rate hikes further out has been tempered. With markets shifting towards serving up a 50bp hike on a platter for September (with 35 points priced in at the time of writing), the path of least resistance looks set to be to take it.

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