

# NEW ZEALAND ECONOMICS

## RBNZ JUNE *MONETARY POLICY STATEMENT* REVIEW

9 June 2011

### CONTRIBUTORS

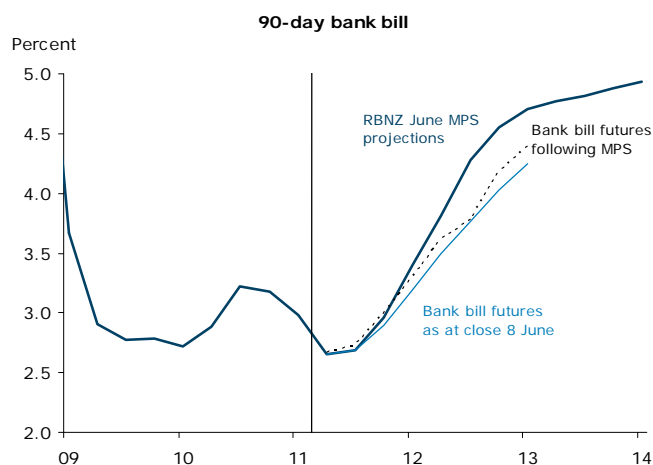
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## RBNZ ON HOLD BUT END OF YEAR HIKE ON THE CARDS

### KEY POINTS

- The RBNZ left the OCR unchanged at 2.5 percent as widely expected.
- The outlook has improved since the last *Statement*, resulting in an upgrade to the RBNZ's growth forecasts.
- With the growth pick-up, the RBNZ sees underlying inflation rising, hence the need for the OCR to move higher to return inflation to the middle of the policy band.
- The key phrase from April that the OCR is "likely to remain appropriate for some time" was removed and replaced with "the pace and timing of increases will be guided by the speed of recovery".
- Everything is now on the table. A pre-December move looks a stretch, but we wouldn't rule out December starting with a 50bp hike despite the RBNZ noting they expected a "gradual" rise in the OCR.
- Inflation expectations are critical to watch over the coming months.
- We are likewise upbeat on the recovery in H2 2011 and expect data to print consistently with an end of year start to the tightening cycle.
- While the RBNZ still appear somewhat frustrated by the level of the NZDUSD, they also appear to be subtly endorsing it to remain higher.
- The end-point of their 90-day projections is some 50bps higher than market pricing by the end of 2012. The endgame for interest rates is still low (sub 5 percent) but higher than previously signalled.
- While financial conditions have tightened post today's *Statement*, the tightening is not material enough in our view to derail the recovery.



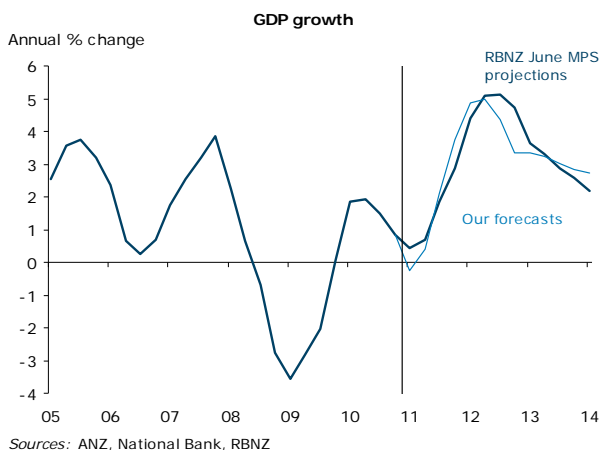
Sources: ANZ, National Bank, RBNZ

## DATA REVIEW

## COMMENT AND ASSESSMENT

**Today's no-change decision was widely expected. What did surprise the market**, leading to a 10bp selloff in rates and sending the NZD over 80 pips higher past 0.8220, **was the RBNZ's upwardly revised 90-day interest rate projection.** The new track is roughly 25bps higher than the March forecasts by the end of 2012, but importantly this is around 50bps higher than market pricing had been. The 90-day track also implies a December start to the tightening cycle, which is in line with our view but was not fully priced by the market – until today. We also suspect a fair bit of today's reaction was merely a consequence of market positioning.

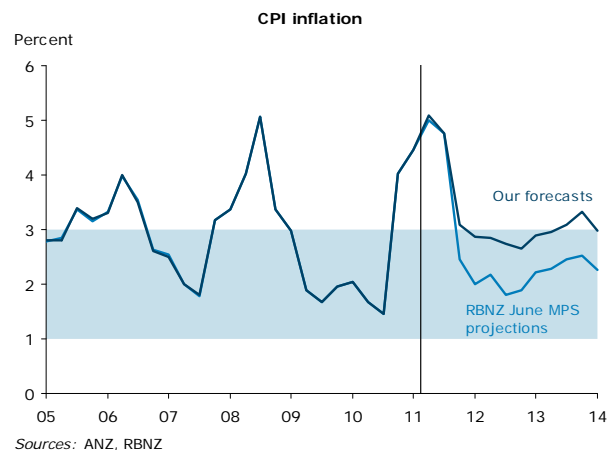
**The reason behind the RBNZ's higher 90-day projection was an upgrade to their growth outlook.** At the March *Statement*, there was a lot of uncertainty about how the economy would evolve following the Christchurch earthquake. Now that the dust has settled somewhat, the picture emerging is of an economy that is faring better than expected. The RBNZ noted that "it appears the negative confidence effect of the earthquake on economic activity throughout the rest of the country has been limited." This resilience, together with the terms of trade at four-decade highs, has seen the RBNZ revise their GDP forecasts upwards.



**The RBNZ's latest growth forecasts are in line with our own** – hence we see little to quibble with. **Where we continue to differ from the RBNZ is on the outlook for inflation.** The RBNZ expects underlying inflation to rise as the economy picks up, but forecasts headline inflation to track close to the midpoint of the target band by next year. In contrast, we struggle to see inflation heading down towards 2 percent, given the various factors (including food prices, rents, and construction-related

prices) that, in combination, look set to keep inflation elevated.

The RBNZ sees underlying inflation as being constrained, but have noted that their statistical measure of core inflation has picked up to above 2 percent over the past two quarters. In addition, **the elevated readings on various inflation expectations surveys are a concern.** There is much discussion in the *Statement* on inflation expectations, a lot more than usual. For now, the RBNZ is looking through the recent spike, putting it down to high petrol prices, which have since subsided. **But should inflation expectations stay high, the RBNZ will not be able to ignore this.**

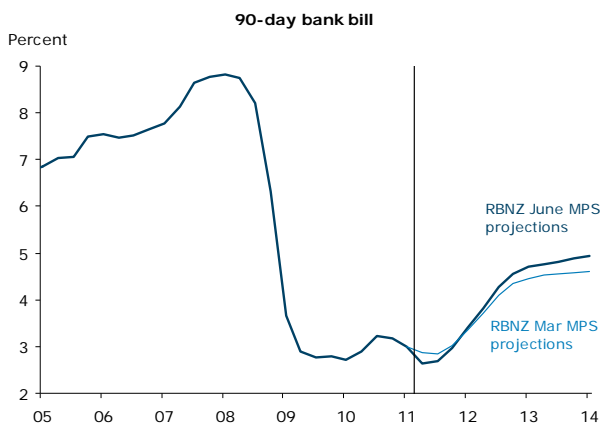


**Another important consideration for the inflation outlook is the view on the extent of spare capacity in the economy.** There is no doubt that there is a negative output gap at present. But how large that is will be a key judgement in terms of how quickly spare capacity gets soaked up and inflation pressures start to emerge. The RBNZ notes that "indicators of excess capacity are mixed, with some suggesting that there is less slack in the economy than might be expected given this weak activity picture." Our view is that the economy has a lower margin of spare capacity, given the lack of investment over the past few years, which is why we think inflation pressures will emerge sooner rather than later.

**The RBNZ sees a need for a gradual increase in the OCR over the next two years**, and as mentioned earlier, their 90-day track implies a December start. The exact timing and pace of tightening will depend on the speed of the recovery. **The RBNZ is willing to be patient for now and wait until they see hard evidence of the recovery in the dataflow.** No doubt they are cognisant of the fact that last year's surge in

## DATA REVIEW

confidence proved to be a head fake, and the RBNZ will not want to make the same mistake again in reacting to confidence readings only for the recovery to fail to take hold. The upward sloping yield curve and high proportion of mortgages on floating rates give the RBNZ confidence to sit on the sidelines for longer.



Sources: ANZ, National Bank, RBNZ

**While the risks to the domestic outlook are to the upside, there are downside risks as well, emanating from offshore.** These offshore risks are well known – the recent softening in global activity could prove to be more persistent, the timing of the Japanese manufacturing recovery from earthquake and tsunami disruptions, European sovereign debt concerns, and the potential for fiscal consolidation in the US to impact on growth.

**There was some mention of the currency constraining the rebalancing of the economy.** The RBNZ's TWI track has it staying at current levels over the coming year before only gradually depreciating. Given high export prices, this is to be expected, and helps to contain inflation further out. But apart from noting that the high currency is negatively affecting the non-commodity parts of the tradable sector, there was no active attempt to try to jawbone the currency down – either in the *Statement* or during the Governor's press conference. This suggests that the RBNZ may be fairly relaxed about the current level of the currency.

The RBNZ outlined three key assumptions underpinning their policy outlook:

- construction cost inflation will be subdued relative to its mid-2000 peak;
- households will continue to focus on reducing debt; and

- recent increases in surveyed inflation expectations will be short lived.

**To us, all three assumptions seem asymmetric in terms of the risk.** We think construction cost inflation will be stronger than expected. Given the amount of resources required for the earthquake rebuild, it is inevitable that there will be a relative price shift. We also see rents starting to pick up as demand for housing starts to outstrip supply.

**The RBNZ's assumption that households will continue to deleverage is a reasonable one. But we think that they (especially farmers) will start to open up their wallets a little.** Households have done much to turn their dismal savings performance around. There is more to go, but much of the hard work looks to have been done. An improving labour market and decent income growth, especially with such a substantial terms of trade boost, means there should be enough cash for households to both reduce debt and spend up a little.

As for the rise in inflation expectations being short lived, time will tell. The next few months' readings on this will be crucial.

In this regard, we note some interesting choice of terminology by the RBNZ. Core inflation is noted as being "*constrained*", as opposed to *contained*. The former highlights the cost-push demand-pull tensions that are more apparent than previously. Also, the current level of the OCR is no longer "likely to remain appropriate for some time"; but rather "the pace and timing of increases will be guided by the speed of the recovery". The NZD's appreciation is "supported by high export prices", although presenting other challenges. The quake impact beyond Christchurch has gone from being "negative" (March *Statement*), to "relatively unaffected" (April review) to now "limited". Subtle but important shifts, in our view.

## IMPLICATIONS

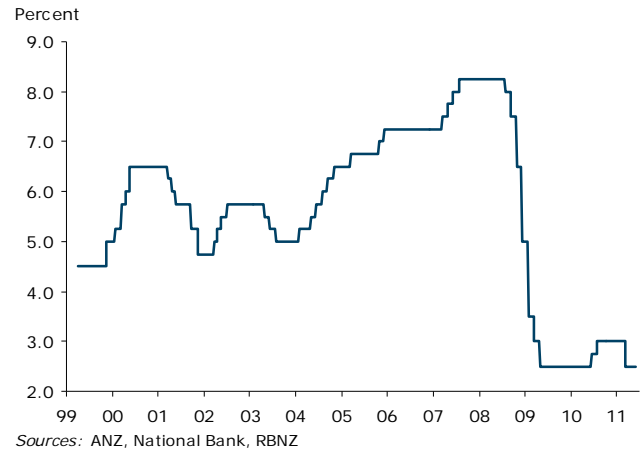
**For now, the RBNZ is in datawatch mode.** While we remain happy with our 25bps December view of the tightening cycle, **we wouldn't rule out the first move being a 50bp increase.** This goes against the grain of "gradual" rises in the OCR and should not be confused with us becoming overtly hawkish. **We expect slow and steady rate increases beyond that and a sub 5 percent OCR endgame.** However, a 2.5 percent OCR simply looks inconsistent with the growth and inflation outlook, and we expect the tenor of data from July in particular to increasingly bear this out.

## DATA REVIEW

**RBNZ JUNE 2011 MPS PROJECTIONS  
(MARCH 2011 MPS IN BRACKETS)**

	90-DAY	TWI (YEAR AVERAGE)	CPI (ANN % CHG)	GDP (ANN AVE % CHG)
Q1 2011	3.0 (3.0)	67.1 (67.5)	4.5 (4.4)	1.2 (0.9)
Q2	2.6 (2.9)		5.0 (5.4)	0.9 (0.6)
Q3	2.7 (2.9)		4.8 (4.6)	1.0 (0.7)
Q4	3.0 (3.0)		2.5 (2.3)	1.5 (1.4)
Q1 2012	3.4 (3.4)	68.5 (67.1)	2.0 (2.1)	2.5 (2.7)
Q2	3.8 (3.7)		2.2 (1.8)	3.6 (4.0)
Q3	4.3 (4.1)		1.8 (2.1)	4.4 (5.0)
Q4	4.6 (4.3)		1.9 (2.2)	4.8 (5.4)
Q1 2013	4.7 (4.5)	67.5 (65.2)	2.2 (2.4)	4.6 (4.7)
Q2	4.8 (4.5)		2.3 (2.5)	4.2 (3.7)
Q3	4.8 (4.6)		2.4 (2.5)	3.6 (2.7)
Q4	4.9 (4.6)		2.5 (2.5)	3.1 (2.0)
Q1 2014	4.9 (4.6)	66.0 (63.5)	2.3 (2.3)	2.7 (1.9)

RBNZ Official Cash Rate


**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 outlook for the New Zealand economy has improved since the publication of the March Statement.

"Economic activity has been significantly disrupted by the Christchurch earthquake. However, while many firms and households – particularly within Canterbury – continue to be adversely affected, it appears the negative confidence effect of the earthquake on economic activity throughout the rest of the country has been limited.

"The early signs of recovery noted in the March Statement have continued. Despite some continuing signs of weakness in the world economy, commodity prices remain very strong and firms expect to increase their hiring and capital investment. Reconstruction in Canterbury is projected to add about 2 percentage points to GDP growth over 2012, and boost the level of activity for several years thereafter.

"Despite the strong outlook for export earnings, household expenditure is expected to grow only modestly. Household debt remains very high and is expected to constrain retail spending and the housing market for some time. Continued fiscal consolidation will also act to dampen activity.

"The New Zealand dollar has appreciated substantially over the past two months. This appreciation, supported by high export prices for primary producers, is negatively affecting other parts of the tradable sector, constraining rebalancing of the New Zealand economy.

"Headline inflation is currently being boosted by recent increases in indirect taxes, food and petrol prices, and surveyed expectations of future inflation have edged up. Despite this, indicators of capacity usage and core inflation suggest underlying inflation remains constrained.

"As GDP growth picks up, underlying inflation is expected to rise. A gradual increase in the OCR over the next two years will be required to offset this, such that CPI inflation tracks close to the midpoint of the target band over the latter part of the projection. The pace and timing of increases will be guided by the speed of recovery, but for now the OCR remains on hold."

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- Placed in statutory management or receivership.

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- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

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- Providing cash;

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- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

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Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

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