Economic Update

RBNZ recycles December's message.

ECONOMICS

28 Jan. 10

OCR Review January 28th 2010

- **OCR unchanged at 2.5%, RBNZ outlook unchanged & sticks to 'middle of 2010' assessment.**
- **Nevertheless, we think the pace of tightening will be more gradual than we previously expected.**
- **We still expect RBNZ to hike the OCR in April, but by 25bp and with a 5% OCR end point.**

There were no surprises in the Bank's statement today. The RBNZ trod a very similar line to the December statement (even going so far as to specifically note that). The key point was that events have kept the RBNZ comfortable with its assessment that "around the middle of 2010" is the appropriate timing to start unwinding the stimulus.

It was a very environmentally friendly statement with the RBNZ recycling many words from its previous statement. The RBNZ noted the NZ economy continues to recover. The Bank has returned to feeling 'comfortable' with the inflation outlook, suggesting the subdued Q4 CPI outturn did in fact bring the RBNZ some breathing space.

We continue to expect the RBNZ to start removing the stimulus in April: the medium-term inflation outlook will appear less "comfortable" over time. However, we now expect the pace of OCR increases to be of 25bp instead of 50bp in the initial meetings. Some of the urgency for rapid tightening has dissipated with signs that the housing market's rise is ending. But a key factor behind our view change is that the relationship between the OCR and lending rates is likely to be a lot firmer than we previously assessed. The likelihood of a large wedge remaining between the OCR and bank funding costs – even after the OCR has risen to more normal levels – also suggests a peak OCR of 5% will be sufficient to remove the stimulus short-term rates provide. Previously, we assumed the OCR would reach 5.5%.

The RBNZ Governor is speaking tomorrow afternoon on "The crisis and monetary policy: what we learned and where we are going." Given the "where are we going" aspect, it is possible the RBNZ talks specifically about its exit strategy. Last year the Governor implied 25bp hikes wouldn't cut the mustard: the speech may give insights into whether the RBNZ has changed its mind or not. Our new view is that 25bp hikes will pack sufficient heat.

Same old, same old

Statement contains same message from December.

The statement itself was very similar to the December statement, with the RBNZ very cautious to not upset the markets with this announcement. Indeed, most parts were essentially unchanged.

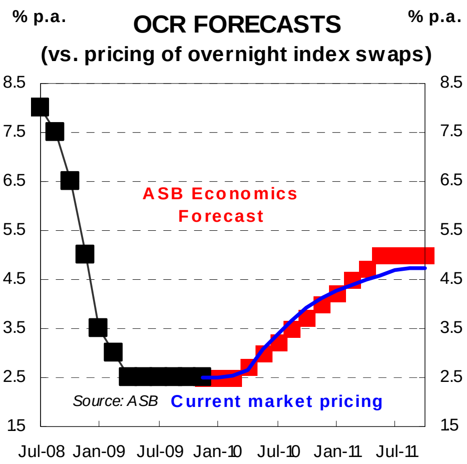
Economic outlook evolves in line with RBNZ forecasts.

The RBNZ noted that global activity continues to recover, pushing NZ commodity prices higher, though noted ongoing concerns around the vulnerability of financial sectors. The NZ economy continues to recover, with the RBNZ acknowledging a pick-up in consumer spending. Nonetheless, households remain cautious and credit growth subdued. Business investment remains weak. There were no surprises here.

Inflation comfortable

RBNZ more relaxed after Q4 CPI inflation.

The RBNZ has brought back is 'comfortable' assessment on CPI inflation forecast. This was absent in December. The RBNZ is potentially feeling more relaxed about the inflation outlook following the subdued Q4 CPI outturn.



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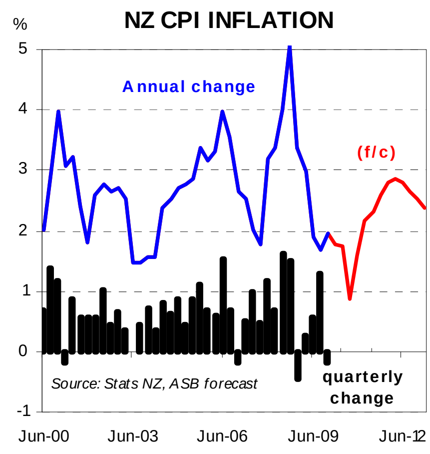
We have concerns for medium-term inflation outlook.

Nonetheless, we are slightly more concerned about non-tradable inflation pressures as our medium-term inflation outlook is now pushing closer toward the top of the band, with upside risks becoming increasingly evident.



Role for fiscal policy

The RBNZ continues to make the not-so-subtle suggestion that fiscal policy could help to reduce the work monetary policy needs to do during the upswing.

Market Reaction

Market unmoved by recycled statement.

The RBNZ statement created no major surprises in the market, and there was little in the way of reaction. The NZD has been weakening since last week, and has been trading around 0.705 this morning, remaining in the range seen over the past 48 hours. Interest rates also showed little reaction, with swap rates ticking up by only 2-3 basis points over the morning. Dr Bollard's on the record speech tomorrow will be the next major focus for the market. However, given the lack of surprise in today's announcement, we do not expect any market moving information to come out of tomorrow's speech in Canterbury.

Market reaction

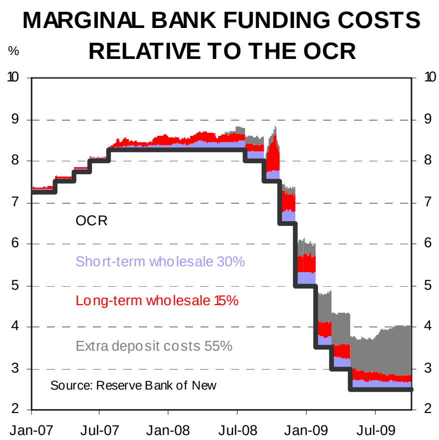
Key Rates	8.55am	10am
NZD/USD	0.7045	0.7061
NZD/AUD	0.7879	0.8946
NZD/EUR	0.5023	0.5036
NZD/JPY	63.35	63.56
NZD/GBP	0.436	0.4368
AUD/USD	0.8945	0.8946
90d bank bill	2.78	2.78
1y swap rate	3.58	3.62
3y swap rate	4.85	4.87
5y swap rate	5.32	5.35

OCR outlook:

RBNZ hikes likely to have a powerful bite.

RBNZ hikes likely to be very powerful.

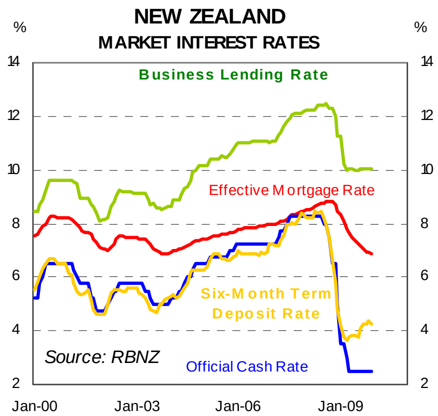
With the economic recovery starting to gain traction, we continue to expect the RBNZ will want to return policy settings closer to a 'neutral' level. However, we have shaved back our assessment of where the neutral cash rate is likely to be, and now see it as somewhere close to 5%. In addition, we expect that the RBNZ will not need to hike the OCR as rapidly as previously thought, and now see 25 basis point steps as more likely. On one hand, the RBNZ has a large gap to close, with 250 basis points of tightening to return the OCR roughly to neutral. However, relatively small increases in the OCR are likely to have a surprisingly powerful effect on lending rates and household behaviour.



Financially sensitive

Economy more sensitive to interest rate movements.

In the post financial crisis environment, the economy is now more sensitive to interest rate increases. In part, this can be attributed to a relatively steep normal-shaped yield curve. Borrowers have become more attracted to shorter-term interest rates, with a notable change in borrower preference to floating or fixed terms of just 6 months. This dynamic will be helpful for the RBNZ as it reduces the lag between OCR increases and higher effective interest rates.



Change to tax policy could also help rein in housing market pressures.

Also increasing the potency of interest rate increases, sensitivity to high debt levels has been amplified by lower income growth and ongoing concerns for job security. Finally, any changes to the tax treatment of housing investment would (if enacted) reduce the tax-related incentives for owning rental property, would reduce the need for monetary policy to rein in housing strength.

Funding costs push up interest rates relative to OCR.

Funding costs

Along with increased sensitivity, a large determinant behind our 5% neutral cash rate estimate is our assessment of future funding cost trends. We note there remains a considerable amount of uncertainty and the cash rate outlook is still contingent on how these aspects evolve over the next few years. Bank funding costs have been pushed significantly higher via retail deposit rates and the credit spread on long-term wholesale bank funding and retail funding. These funding costs have placed a wedge between the OCR and retail interest rates. We had previously expected this wedge would continue to narrow over the next couple of years.

Lowers the 'neutral' cash rate to around 5%.

However, credit spreads on term wholesale funding have stopped narrowing. Meanwhile the 'retail deposit war' is unlikely to let up, with the RBNZ's new liquidity policy keeping up the focus on retail deposits. In a global environment where competition for funds is likely to remain tight, we expect these funding pressures to persist. As a result we assume the current wedge between the OCR and banks' funding costs is unlikely to narrow significantly in the near term. To put some numbers on it, to get retail borrowing rates back to neutral/average levels, we estimate an OCR of only 5% is necessary, compared to 6.25%-6.5% pre-financial crisis.

Less urgency

Rising interest rates reduce urgency to normalise OCR.

We have also changed our view on the pace of OCR hikes, as we no longer see quite the same urgency for a higher OCR. In particular, mortgage rates have increased considerably over recent months, reflecting rising funding costs. This higher starting point reduces some of the necessity for 50 basis point moves. We were originally worried that the RBNZ might be behind the curve by this point in time, but it turns out pre-emptive increases in mortgage rates have done some of the work for it. Furthermore, a series of 50bp hikes would likely have short-term mortgage rates back around average levels within a 6-month period – quite a rapid removal of stimulus.

Slowing housing market also reduces need for aggressive action.

Additionally, recent housing market data suggest momentum is starting to wane. The mini-fire in the housing market is possibly starting to die out on its own accord, reducing the urgency for strong policy action from the RBNZ. We expect that supply and demand to become more balanced over the next year. In addition, the rise in house prices has had a relatively muted impact on household credit growth, which was the RBNZ's primary concern.

All eyes on Friday's speech

Watching for signal from RBNZ, if prefers 25s or 50s.

When we originally set our view for 50 basis point hikes, we were taking particular notice of Alan Bollard's own comments. The Governor had made passing comment that, when rates are at extraordinarily low levels, withdrawing stimulus in 25bp steps can take too long. The Federal Reserve's slow pace following the dotcom bust ended up fuelling a housing bubble with disastrous consequences. Nonetheless, since Alan Bollard made those comments, funding costs have remained surprisingly elevated and mortgage rates have increased earlier than expected. The RBA has also hiked by 'only' 25bp whilst also dealing with a stronger (and stronger than expected) economy. We will be watching Dr Bollard's comments in Friday afternoon's on-the-record speech very closely. In particular, we will be looking for some clues to the RBNZ's current thoughts on the pace of OCR hikes. One irony for us would be to have the Governor still signal larger hikes are more appropriate, though our work suggests it would be worth testing the waters with small hikes first.

Implications – Gradual rate hikes likely

RBNZ stance currently unchanged.

As expected, the RBNZ trod a very similar line to the December statement (even going so far as to specifically note that). The key point was that events have kept the RBNZ comfortable with its assessment that "around the middle of 2010" is the appropriate timing to start unwinding the stimulus. There was little market reaction.

We continue to expect April hike, but now just 25bp.

We continue to expect the RBNZ to start removing the stimulus in April: the medium-term inflation outlook will appear less "comfortable" over time. However, we now expect the pace of OCR increases to be of 25bp instead of 50bp in the initial meetings. Some of the urgency for rapid tightening has dissipated with signs that the housing market's rise is ending. But a key factor behind our view change is that the relationship between the OCR and lending rates is likely to be a lot firmer than we previously assessed. The likelihood of a large wedge remaining between the OCR and bank funding costs – even after the OCR has risen to more normal levels – also suggests a peak OCR of 5% will be sufficient to remove the stimulus short-term rates provide. Previously, we assumed the OCR would reach 5.5%

Our view on the timing and magnitude of future OCR moves is fairly close to current market pricing.

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Full RBNZ January OCR Statement

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: "The outlook for the New Zealand economy remains consistent with the projections underlying the December Monetary Policy Statement.

"Global activity continues to recover, helping push New Zealand's export commodity prices higher. Economic growth is most apparent in China, Australia, and emerging Asia. However, sustained growth throughout our trading partners is not assured, with many still facing impaired financial sectors and overall activity still reliant on policy support.

"Similarly, the New Zealand economy continues to recover. Policy stimulus and improving export earnings have seen a pickup in household spending. That said, households remain cautious, with credit growth subdued. Business spending remains weak.

"Annual CPI inflation is currently at the centre of the target band, and is expected to track comfortably within the band over the medium term.

"The economy is being assisted by both monetary and fiscal policy support. As growth becomes self sustaining, fiscal consolidation would help reduce the work that monetary policy might otherwise need to do.

"If the economy continues to recover in line with our December projections, we would expect to begin removing policy stimulus around the middle of 2010."

Some background to the event

OCR formally reconsidered every 6-7 weeks

The Reserve Bank of New Zealand (RBNZ) releases a Monetary Policy Statement (MPS) each quarter outlining its thinking about the economy, especially future growth and inflation rates.

At the Statements and at mid quarter Reviews the RBNZ take the opportunity to review the setting of the Official Cash Rate (OCR) target.

The OCR target effectively locks the level of wholesale overnight rates. Other wholesale short-term interest rates change to reflect anticipations of where the OCR might be in the ensuing weeks. In turn, the retail rates set by the banks will adjust to the level of wholesale rates.

Wholesale and retail rates need not adjust in the same direction and magnitude of any OCR change. The reaction will depend on the extent to which the RBNZ action has already been anticipated and built into rates.

While interest rates are a key factor in exchange rate determination, the exchange rate may or may not also respond to changes in the level of short-term rates. Other factors may also come into play at the time.

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