

Pace and extent

July 29 OCR review: RBNZ hikes another 25bp to 3.00%

- **The RBNZ increased the Official Cash Rate to 3.00% as expected.**
- **In light of recent data, the RBNZ signalled a more moderate tightening over the course of the next couple of years, compared to its June projections.**
- **However, the statement was unusually clear that further hikes are likely in the near term.**

The RBNZ's decision today to increase the OCR another 25 basis points was widely anticipated. But whereas we thought they could have retained much of the language of the June media release, instead they went for a complete rewrite that offered up a few surprises. On balance it was a softer statement than we expected, but the signal on near-term policy intentions was unusually explicit by the RBNZ's standards.

The softer tone to the economic data in recent weeks, both here and overseas, had prompted some suggestions that the RBNZ should be pausing around this point to assess the situation. Today's statement shot down that notion from the get-go: "it is still appropriate to continue to reduce the extraordinary level of support implemented during the 2008/09 recession", later noting that "even after today's move, the level of the OCR is still very supportive of economic activity."

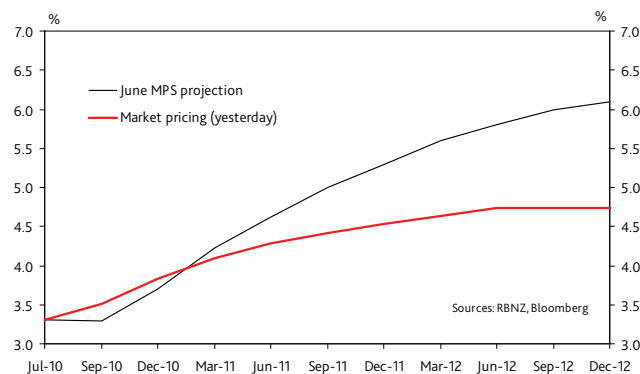
Compared to the fairly anodyne statement in June that "the further removal of stimulus will be reviewed in light of economic and financial market developments", that's a fairly strong signal that the RBNZ intends to plough ahead with more hikes over the next few reviews. The OCR is still a long way from what could be called neutral, and recent news aside, the risks to the economy are still very much two-sided. A prudent central bank would rather be closer to neutral before considering any meaningful pause.

But looking further ahead, the crucial statement was that "the pace and extent of further OCR increases is likely to be more moderate than was projected in the June *Statement*". We're not surprised that the recent data would warrant a slower pace of tightening in their forecasts, relative to the front-loaded track that was projected in June. But "extent" implies the RBNZ has

also lowered the expected end-point for the tightening cycle two years or so down the track. We won't know whether there's been a meaningful change until the next set of projections in September. But that's a stronger reaction to a handful of softer short-term data than we would have expected.

What's more, it serves to highlight a yawning gap between the message the RBNZ is trying to send, and the one that the market is receiving. The June *MPS* projections suggested an OCR peaking at 5.5-6.0% a couple of years from now – presumably that peak would be a bit lower now (*Figure 1*). But even before today, interest rate markets were pricing in a peak of more like 4.5%, which was the record low in the OCR prior to the financial crisis. Even the "new neutral" proponents would struggle to justify topping out at such a low level. The fact is that the RBNZ has struggled to create buy-in to the idea of a return to 'normal' policy settings.

Figure 1: 90-day rate expectations



It's not for lack of trying though – if anything, today's statement hammered the inflation message even harder. The comment in June that "underlying CPI inflation is expected to track within the target range even as the economy expands further" was gone, replaced with "as the economy grows, inflationary pressures are expected to pick up", with no inference about whether they will remain contained.

Headline inflation is set to spike to around 5% by the middle of next year due to a range of government policy-related price

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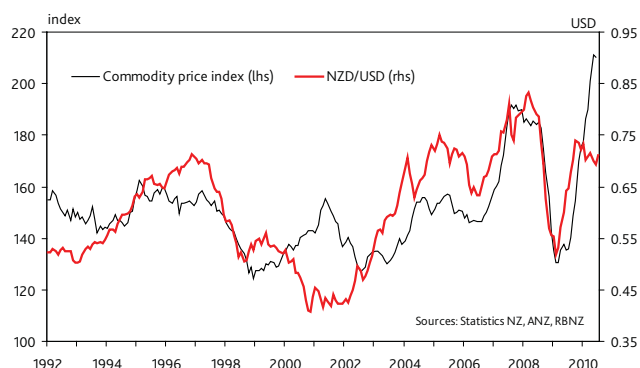
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hikes. The RBNZ is assuming these won't have any lingering effects on inflation, but they seem increasingly concerned about this possibility: "the price and wage setting behaviour of firms and households will be monitored for evidence of any increase in inflation expectations". We find this logic to be a bit backwards. Inflation expectations have already risen; the issue now is whether they are acted on in wage- and price-setting behaviour. By the time we observe that, it will be too late.

Another notable omission from today's statement was the reference to mitigating factors that might warrant less tightening: higher bank funding costs, a steep yield curve and a higher share of borrowers on floating rates. As we've pointed out before, none of these factors are substantially different from the start of previous cycles.

There was, however, an acknowledgement of the recent gains in the New Zealand dollar, which the RBNZ sees as inconsistent with the evolving economic outlook. We're more relaxed about this issue. The rise since June only puts the trade-weighted index back near the top of a range that it has maintained since last September. Moreover, the NZD never matched the most recent run-up in world commodity prices (*Figure 2*), leaving a gap that was likely to close through either a rise in the exchange rate, or an easing in commodity prices as more global supply came on tap. It's not inconsistent to see both at once.

Figure 2: NZD and commodity prices, adjusted for inflation



Market implications

The market pounced on the comment about a more moderate pace and extent of tightening, sending the NZD down half a cent to 0.7230 and the two-year swap rate down 10bp to 4.08%. Market pricing suggests a two-thirds chance of another 25bp hike in September, roughly unchanged on the day. We think today's statement actually raises the odds of a September hike – or at least makes it less data-dependent – since the RBNZ seems uncomfortable with the idea of pausing while the OCR is still at such stimulatory levels.

Our view remains that the RBNZ will continue to work its way towards a peak in the OCR of 6% by early 2012. That would be consistent with a 25bp hike at every review, though we'd suggest that as more of a probability-weighted track. There could well be some pauses along the way, but equally there could be some

larger hikes; there's simply no mileage in trying to pin down a date for either.

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RBNZ media release

The Reserve Bank today increased the Official Cash Rate (OCR) by 25 basis points to 3.0 percent.

Reserve Bank Governor Alan Bollard said: "While the outlook for economic growth has softened somewhat, it is still appropriate to continue to reduce the extraordinary level of support implemented during the 2008/09 recession.

"The world economy continues its fragile recovery. Trading partner growth has turned out stronger than we predicted, however, future prospects for growth have deteriorated. While still at high levels, our commodity prices have moderated.

"In New Zealand, domestic demand is subdued. Households are cautious, with retail spending growing only modestly, housing turnover in decline and household credit growth weak. While this caution has been evident for some time, the recent slowing in net immigration will act to further dampen consumer spending. Business investment remains very low, with corporate lending continuing to be subdued.

"The New Zealand dollar has appreciated in recent weeks. This appreciation is inconsistent with the softening in New Zealand's economic outlook and moderation in our export commodity prices.

"Overall, we continue to predict respectable near-term GDP growth, with manufacturing confidence remaining elevated and forestry exports continuing to expand. An eventual recovery in business investment will assist growth over the medium term.

"Annual CPI inflation has been near 2 percent for the past five quarters. As the economy grows, inflationary pressures are expected to pick up.

"Given this, some further removal of monetary policy stimulus is appropriate at this stage. Even after today's move, the level of the OCR is still very supportive of economic activity. The pace and extent of further OCR increases is likely to be more moderate than was projected in the June Statement. Our policy assessment will be continually reviewed in light of economic and financial market developments.

"The coming increase in the rate of GST and other government-related price changes are likely to temporarily push annual CPI inflation above 3 percent. The Bank does not expect this price spike to have a lasting impact on inflation. However, the price and wage setting behaviour of firms and households will be monitored for evidence of any increase in inflation expectations."