Economic Update
RBNZ October OCR Review
20 October 2011

Sidelined by Europe

- **RBNZ to leave OCR unchanged at 2.5%.**
- **Global outlook has deteriorated while large uncertainties remain around the Eurozone situation.**
- **Weaker local data also suggest less urgency for OCR increases in the short term.**

We expect the RBNZ to leave the OCR unchanged at 2.5% at the October OCR review (Thursday 27th October, 9am). Uncertainty around the global outlook stemming from the Eurozone sovereign debt crisis continues to dominate the economic outlook. The risk the Eurozone situation could deteriorate and spark a second major financial crisis remains unacceptably high. In addition, the RBNZ will be wary of continued theatrics from American politicians as the US debt ceiling issue returns to focus later this year.

Domestic developments have also been less rosy in recent weeks, with economic growth weaker than expected over Q2, and indicators highlighting a still-fragile recovery. Overall, there is no urgency for the RBNZ to increase interest rates in the coming months. The RBNZ will remain on the sidelines until confidence in Europe returns. Assuming some resolution is found in the coming months, we expect the RBNZ to lift the OCR by 25 basis points in March, and at each consecutive meeting bringing the OCR to a peak of 4%.

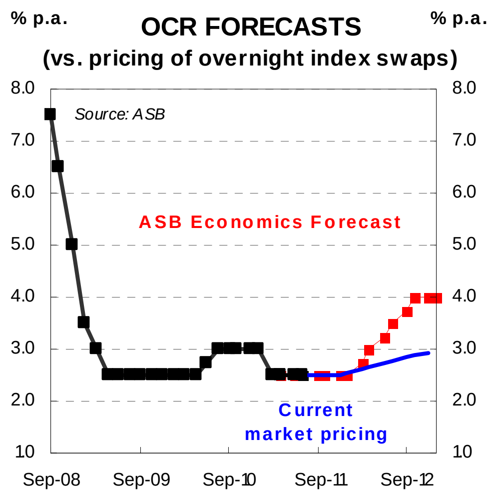
Global growth outlook deteriorates further.

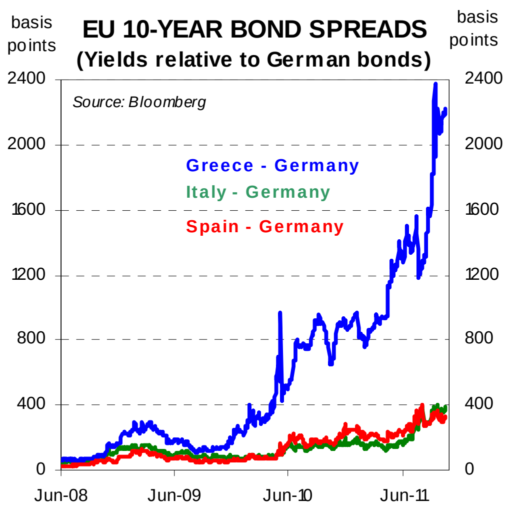
Global uncertainty dominates

The global economic outlook has deteriorated since September. Forecasts for trading partner growth have been revised down steadily in recent months. Further, the revisions are no longer isolated to US, UK and Europe, with forecasters becoming more wary of the flow-on impacts to economic activity in developing Asia. In addition, large downside risks to the outlook remain as the Eurozone sovereign debt crisis has yet to be resolved.

Eurozone risks unacceptably high.

The risks to the global outlook stemming from the Eurozone sovereign debt crisis remain unacceptably high, and will keep the RBNZ on the sidelines until March next year. Over recent weeks, it has been encouraging to see European politicians taking Greek's insolvency and European banking stress more seriously. Nonetheless, a comprehensive plan to resolve some of the debt contagion concerns could still be some time away. Indeed, Greek bail-out measures announced back in July took a long time to get official approval and German officials recently noted that the crisis is likely to extend into next year. As such, there still remains plenty of scope for failure in resolving the crisis in coming months. In the meantime, the European banking system remains strained and vulnerable. The longer the crisis continues, the more likely NZ would feel the financial impacts given its dependence on offshore funding. One of the RBNZ's key concerns at the September MPS was a potential rise in funding costs over the coming year.





Nick Tuffley Chief Economist – 649 301 5659 – nick.tuffley@asb.co.nz
Jane Turner Economist – 649 301 5660 – jane.turner@asb.co.nz
Christina Leung Economist – 649 301 5661 – christina.leung@asb.co.nz

US debt ceiling drama not over yet.

Meanwhile, the US political environment is also concerning, with the RBNZ wary that the debt ceiling debacle is not yet over. In November, a bipartisan congressional committee tasked with finding $1.5 trillion of further deficit reductions is due to report back. If the committee fails to reach an agreement or its proposal is rejected, then $1.2 trillion in spending cuts will be automatically triggered, drawn equally from domestic spending and defence. These automatic spending cuts would be very damaging the US economy, raising the chances of a double-dip recession over 2012.

Too much uncertainty leaves RBNZ on sidelines for now.

Overall, a large degree of uncertainty around the global economic outlook remains, although this is mostly a result of political dithering. At this stage, the RBNZ cannot rule out a second financial crisis triggered by a nasty turn in the Eurozone sovereign debt crisis. While such an event is considered a low probability, it could have a severe impact on the global economic outlook. European and US political developments will keep the RBNZ on the sidelines for the time being, with the weaker NZD since early August providing a helpful buffer against the heighted uncertainty.

Domestic recovery still fragile

Weaker starting point for growth highlights lack of urgency.

Besides the increased downside risks to the growth outlook as a result of the heightened uncertainty around global developments, the domestic growth outlook is also looking slightly less rosy since the September MPS. The NZ economy barely grew over Q2, with the 0.1% increase in activity much weaker than the 0.6% expected by the RBNZ at the time.

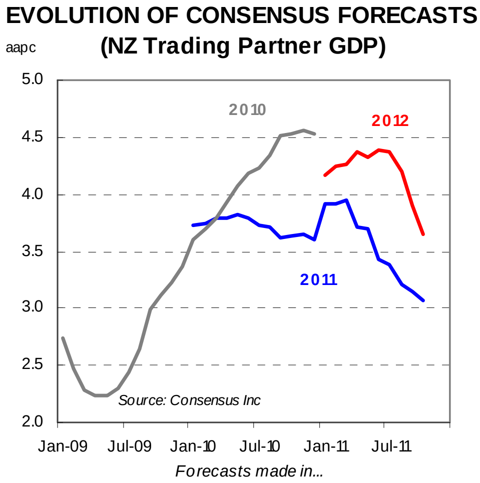
Indicators point to fragile recovery.

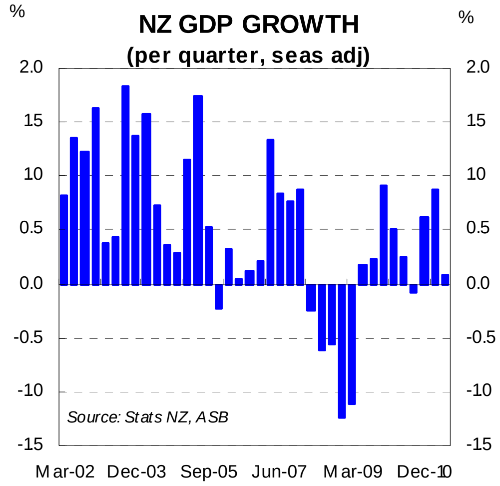
More recent activity indicators point to the recovery in the NZ economy remaining very gradual. Early indicators of spending growth suggest demand from households remains lacklustre. Housing turnover has plateaued in more recent months. However, the fact that there is a continued recovery in house prices suggests this slowing in activity reflects the housing market being constrained by supply.

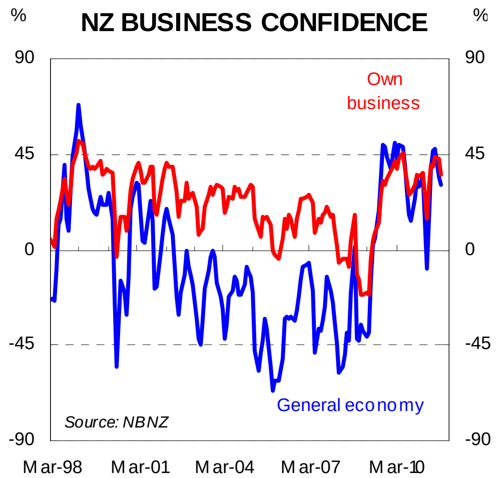
Encouragingly, business confidence has been resilient despite the knock from the global turbulence, with businesses indicating they still intend to put in place expansion plans via investment and hiring. Consumer confidence has also remained relatively resilient. Nonetheless, credit growth remains weak, suggesting businesses and households remain cautious.

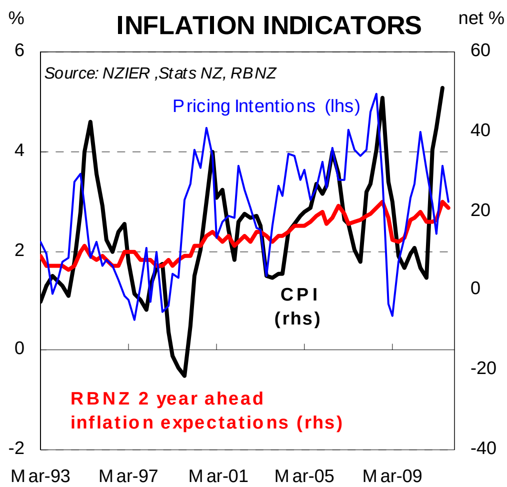
Inflation pressures subdued for now.

Meanwhile, inflation indicators suggest underlying inflation pressures are contained for now.









There has been an easing in pricing intentions and medium-term inflation expectations more recently, which allows the Reserve Bank some breathing space.

Funding cost outlook wildcard.

The increase in funding pressures since the flare-up of the Eurozone debt crisis adds to the case for the Reserve Bank to hold fire for now. The recent downgrade to NZ's credit rating by Fitch and Standard & Poors also has the potential to push up funding costs for banks in NZ, at the margin.

Global uncertainties overshadows outlook.

Implications – cautious optimism

Recent developments suggest it would be wise for the Reserve Bank to remain cautious, and wait on the sidelines until the outlook becomes clearer. Increases in the OCR will be largely dependent on the global outlook, and specifically developments in Europe. While the RBNZ remains optimistic on the domestic growth outlook, data released more recently suggest a weaker starting point for the NZ economy. Overall, there is little urgency for the Reserve Bank to return monetary policy to normal settings, particularly in light of the continued turbulence offshore.

OCR back to 4% when/if Eurozone situation settles down.

With concern about the escalating debt crisis in the Eurozone dominating RBNZ's outlook, we expect the RBNZ will leave the OCR on hold until March next year. We expect the RBNZ to lift the OCR by 25 basis points in March and at each consecutive meeting, bringing the OCR to a peak of 4%. Given the likelihood of ongoing global uncertainty and increased NZ household sensitivity to interest rate increases, the risk is the increases in the OCR will be more drawn out, with the RBNZ pausing at some point along the way.

OCR formally reconsidered every 6-7 weeks.

Background to the data

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.

ASB Economics & Research			Phone	Fax
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659	(649) 302 0992
Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5660	
Economist	Christina Leung	christina.leung@asb.co.nz	(649) 301 5661	

https://reports.asb.co.nz/index.html
ASB Economics
Level 9, 135 Albert Street, Auckland