ECONOMICS

10 Sep. 10

Economic **Update**

Pause and assess

Preview of September 16th Monetary Policy Statement

- **We expect the RBNZ will leave the OCR on hold at 3% at the September MPS.**
- **The recent earthquake in Christchurch increases uncertainty over the near-term growth outlook.**
- **Nonetheless, inflation remains a medium-term issue and the OCR will rise next year.**

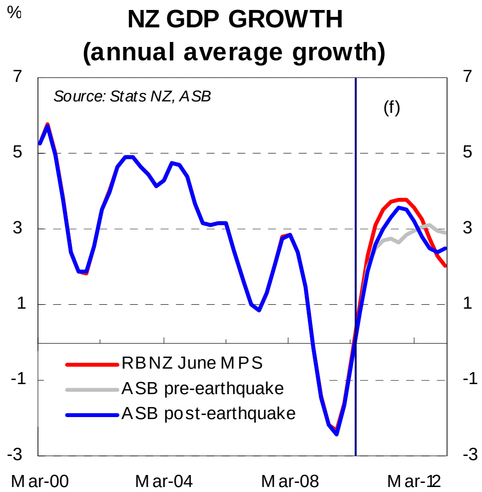
Recent developments mean the RBNZ will err on the side of caution and hold off raising the OCR at the September meeting. It is clear from the July OCR Review Statement that recent economic data have not lived up to the RBNZ's optimistic forecasts. Added to that, there is increased uncertainty over the growth outlook stemming from the US and China. The recent Canterbury earthquake only serves to reinforce our expectations of a September meeting pause, given uncertainty over the net effect of the earthquake on economic activity and the potential for greater business fragility.

Domestic data indicating inflation pressures in the NZ economy are subdued in the near term mean the RBNZ will see little urgency to raise the OCR. Indeed, RBNZ Governor Bollard noted in a recent speech that the RBNZ was "comfortable" with the inflation outlook. Prior to the earthquake, we expected the RBNZ to pause at both the September and October meetings, but it is now likely the RBNZ will remain on hold until early 2011. Aside from greater uncertainty caused by the earthquake, confidence is likely to be more fragile in the short term. However, the OCR will eventually need to start rising and, with Q3 GDP released in late December, January is likely to be the first 'live' meeting for the RBNZ to consider an OCR increase.

RBNZ faces weaker growth outlook

Economic data have not lived up to the RBNZ's optimistic expectations.

On balance, the RBNZ is likely to be facing a weaker growth outlook relative to that at the time of the June MPS (putting the earthquake impact to one side). Granted, this partly reflects the fact the RBNZ was overly optimistic on growth in the first place. Nonetheless, this translates to an assessment of reduced inflationary pressures in the NZ economy.



The rebound in the unemployment rate would have been a key surprise for the RBNZ. The Household Labour Force Survey showed a sharp increase in the unemployment rate to 6.8% in Q2, against RBNZ expectations that the unemployment rate would remain unchanged. While the exceptional degree of volatility in the unemployment rate has made interpreting the data extremely difficult over the past year, overall the trend in the labour market appears much weaker than RBNZ expected. This suggests subdued wage growth over the coming year, which reduces some of the domestic inflationary pressures.

RBNZ has revised down its inflation forecast

In a recent speech, RBNZ Governor Bollard noted it had revised down its inflation forecast. The easing in two-year ahead inflation expectations in the latest RBNZ survey would have given the RBNZ confidence that inflation expectations are contained, at least for now. The RBNZ is now "comfortable" with the inflation outlook, despite the boost to headline CPI from the raft of Government charges over the year. We expect these Government charges will boost annual headline CPI to over 5% by the middle of next year, and see risks of this flowing through to changes in price and wage setting behaviour.

In terms of economic activity, the RBNZ is facing a weaker start to 2010 - Q1 GDP was softer than the RBNZ forecast, and recent activity indicators suggest this will also be the case for Q2 even before the impact of the Canterbury earthquake has been taken into account, As for the second half of 2010, we estimate the earthquake will see muted GDP growth of around 0.5% in Q3 (previously 0.8%), but that Q4 GDP will grow 1.4% as many businesses resume

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normal operations and reconstruction activity kicks in. That nets out to a growth profile which is similar to RBNZ's forecasts for 2010 H2, but implies a weaker underlying performance outside Canterbury than the RBNZ assumed.

Downward trend in business confidence suggest some downside risk to growth

Adding to the increasingly cloudy growth outlook has been the easing in business confidence in recent months. While the current level of business confidence still points to a reasonable pace of recovery for the NZ economy the downward trend is of some concern as it suggests downside risks to growth. Furthermore, the easing in manufacturing sector sentiment raises some question marks over the sustainability of the recovery in manufacturing activity. The earthquake and, at the margin, the receivership of South Canterbury Finance, risk knocking sentiment further.

The outlook for growth in NZ's trading partners has been mixed. Growth concerns surrounding Eurozone have been supplanted by increasing concerns over the sustainability of the recovery in the US economy. While US activity data do point to slowing economic activity, we see the potential for a double-dip as low at this stage. Nonetheless, the slow pace at which the US recovery is occurring raises concerns about the effects on the NZ economy. These concerns are likely to be front-brain for RBNZ Governor Bollard on his return from the recent gathering of central bankers in Jackson Hole in the US.

Furthermore, NZ's export sector relies on demand from China, both directly and indirectly. NZ's exports of dairy and forestry have benefited directly from stronger Asian demand. Meanwhile, the manufacturing sector has started to benefit from stronger demand from Australia, which in turn reflects the benefits of strong Chinese demand for Australia's hard commodities. More recently, attempts by the Chinese authorities to tighten monetary conditions have seen growth slow to a more sustainable pace.

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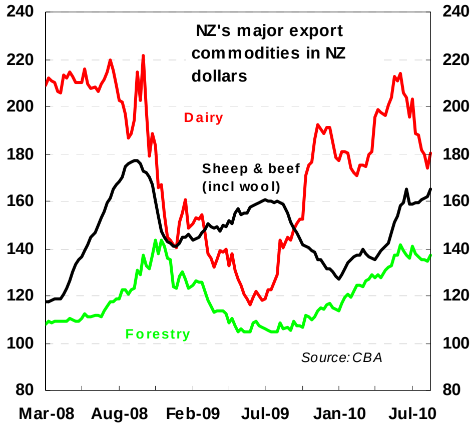


Partly reflecting this, there has been a plateau in forestry prices, one of the key commodities that NZ exports. NZD dairy prices remain 25% off 2007 peaks, despite the rebound in the Fonterra globalDairy Trade auction on September 2nd.

Subdued housing market activity recently in line with RBNZ expectations.

Housing market activity has remained subdued in recent months, but this is in line with RBNZ's expectations. Meanwhile, net immigration rebounded in July following two months of weak inflows. At the time of the June MPS, the RBNZ had banked on above-average population growth, and from the July statement it is clear the weaker net immigration had begun to cause some concern. The latest rebound would have removed some of the downside risk to the recovery in the household sector.

Other positive news in recent months has been the stronger than expected rebound in retail sales volumes in Q2, though discounting looks to have played a part in encouraging sales. Nonetheless, the broad-based nature of the increase in sales points to a genuine recovery in discretionary spending beyond the bringing forward of sales in anticipation of the GST increase in October.

RBNZ will err on the side of caution after the earthquake

Earthquake implications for monetary policy.

The impact of the earthquake will be more inflationary than not. Construction materials and services are likely to be the biggest area of potential price pressure given the huge extent of urgent reconstruction work to do.

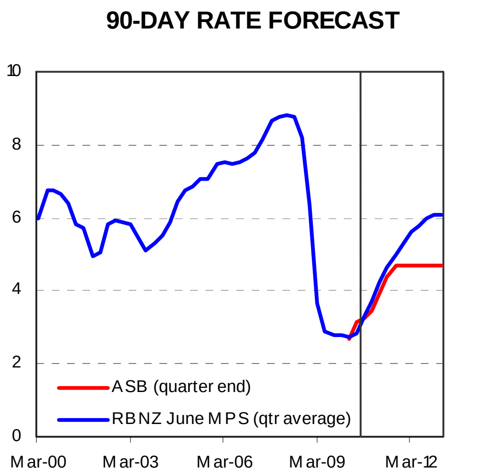
This does not mean the RBNZ will be rushing to lift interest rates, quite the contrary. Clause 3a of the Policy Targets Agreement allows for the RBNZ to look through inflation impacts that "would normally be temporary", including "a natural disaster affecting a major part of the economy". Furthermore, our initial view is the inflation impact will be very modest. If anything, the RBNZ will be even more cautious.

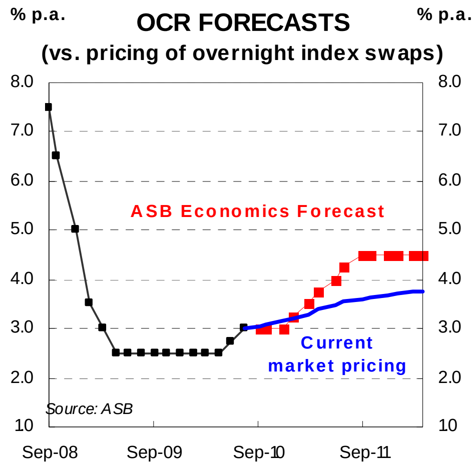
The wildcard risk is the RBNZ actually cuts the OCR if the economic damage from the earthquake looks severe and spreads outside the immediately-affected region: the earthquake has come at a time when many businesses around the country are struggling to overcome the recession. But from Canterbury's narrow point of view the more effective and important support for its economic health is coming from the numerous responses that have kicked into action to minimise disruption, provide direct financial support, and enable as many businesses as possible to resume operations quickly.

Issues to weigh up

Room for regret.

When the outlook is rife with uncertainty, often the best decision-making tool is regrets analysis i.e. which scenario would the RBNZ regret the most if the outlook is different than forecast. If the recovery turns out weaker than expected, and the RBNZ has increased interest rates too fast too soon, it would choke off the fledging recovery. On the other hand, if the underlying recovery is stronger than expected, and the RBNZ has been too slow to increase interest rates, it would allow inflation pressures to get out of control. It can be difficult and costly (in terms of higher interest rates) for a central bank to bring inflation pressures back under control. Nonetheless, the balance of risks around growth currently point to the downside. Further, the recent subdued reading in inflation expectations allows the RBNZ breathing space in erring on the side of not going.





Far from neutral?

Another issue is how far away is the RBNZ currently from neutral monetary policy settings? A recent poll of economists revealed the range of estimates for the neutral OCR of between 4.5-6%. We are at the bottom end of that range at 4.5%, and we struggle to see how it could be much higher over the next few years. Assuming that lifting the OCR 150 basis points will add at least 125 basis points to the floating rate (if not more), the floating rate would lift to 7.5% - with fixed interest rates likely to be at premium to the floating rate. This brings mortgage rates back around long-run averages and, with a subdued household sector, we see little need to do much more. With the OCR at 3.0%, we think the RBNZ is a lot closer to neutral than it appeared to think it was when it released the June MPS. Indeed, the RBNZ's June MPS projections incorporated a 90-day interest rate of 6% which seemed much too high to us.

Credit demand weak.

Finally, monetary policy targets inflation by influencing appetite for debt and through debt servicing affecting discretionary spending. Credit growth remains extremely weak, with demand for business credit yet to follow the recovery seen in GDP growth. In addition, a number of small businesses are still only just holding on, and a lift in debt servicing costs would place them under added financial stress. Moreover, domestic spending remains moderate despite lower interest rates. With these monetary policy channels subdued, this buys the RBNZ more time.

RBNZ forecast changes

The RBNZ's recent communications have indicated that revisions have been made to its forecasts since the June MPS. In particular, Governor Bollard's speech noted it had revised down inflation and now expects the peak in annual headline CPI to be at or slightly below 5%. Regarding the earthquake, there is the possibility the RBNZ may not have had time to incorporate the full effects into its set of forecasts. Hence we expect the September MPS GDP forecast to show a downward revision similar to our pre-earthquake forecast (see chart on first page). The 90-day profile is also expected to be lower, and we expect the September MPS projection to indicate a peak in the OCR of around 5.5%.

The statement accompanying the MPS, which will be finalised in the week of the MPS release, will likely include clarification on how the RBNZ plans to respond to the earthquake. We expect the statement to note that the RBNZ plans to look through the temporary inflation pressures emanating from the earthquake, as in Clause 3a of the Policy Targets Agreement.

Implications

Preventing the recovery from getting off-track primary concern for RBNZ.

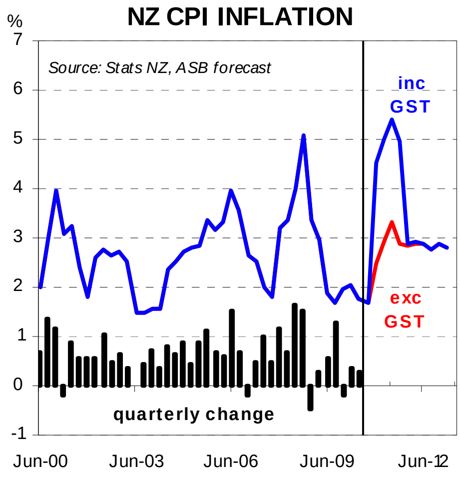
The RBNZ's growing disquiet over the pace of the recovery suggests it is more concerned with the risk of reducing monetary policy stimulus too soon. With activity data coming in below the RBNZ's optimistic June MPS forecasts, it appears the possibility of stifling the economic recovery is now the key policy risk in the short term. The recent Canterbury earthquake serves to add to that uncertainty, and reinforces our expectations that the RBNZ will choose to keep the OCR on hold for at least the rest of the year.

Nonetheless, we continue to see inflation as the key issue over the medium term. We expect the host of Government charges will boost headline CPI inflation to well over 5 percent by the middle of next year, with underlying inflation pressures gradually building in the background.

Reconstruction activity will place pressure on resources.

Meanwhile, the reconstruction process is likely to place pressure on construction industry resources next year. While the Policy Targets Agreement allows the RBNZ to look through the temporary effects of Government charges and natural disasters, it will need to respond to any signs of a lift in wider inflation as a result of these factors.

One thing is certain: the OCR will need to rise (eventually) from current low levels. The key question is timing. Recent events leave the RBNZ with enough reason to pause and assess the current state of the NZ economy. The key job for it now is to wade through the cloudy outlook and determine when a lift in underlying inflation pressures will warrant resuming reduction of monetary policy stimulus.



January likely to be the first 'live' meeting.

For now we expect the RBNZ will at least want to look at the Q3 GDP release to ascertain the impact of recent events on economic activity. As such, we now see January as the first 'live' meeting for the RBNZ.

Notwithstanding the fact that the RBNZ is likely to be pausing for several meetings, current market pricing of an OCR peak at 3.8% remains low although a correction could be awhile away.

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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