NEW ZEALAND ECONOMICS
RBNZ OCTOBER OCR REVIEW

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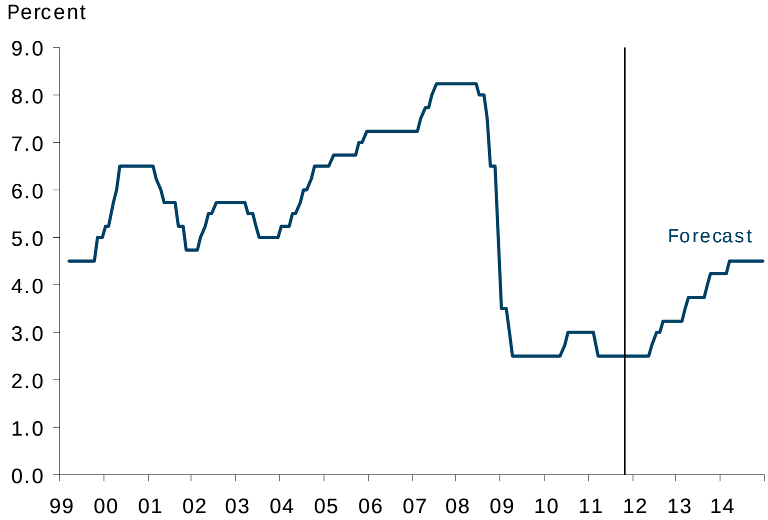
NO RUSH

KEY POINTS

- The OCR was left unchanged at 2.5 percent as widely expected.
- Global events remain a key focus for the RBNZ, who are clearly watching bank funding costs closely.
- The weaker Q3 CPI print has given the RBNZ more room to leave the OCR where it is. It is clear that a 2.5 percent OCR is now seen as an appropriate setting, rather than an “emergency” one.
- The next move in the OCR is still up, but only “if global developments have only a mild impact on the New Zealand economy”.
- We maintain our view of a mid-2012 OCR increase but the risk profile is clearly towards later as opposed to sooner in our minds. This is based on our view that: (a) we are starting to see more than a “mild” impact on New Zealand from the global scene (based on anecdotes as opposed to hard data); and (b) the consensus is too upbeat on how quickly the European situation could settle despite the best efforts of policymakers.

Official Cash Rate



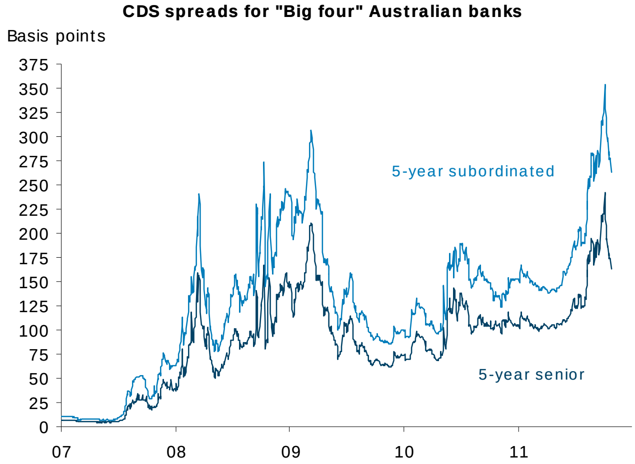
Sources: ANZ, National Bank, RBNZ

DATA REVIEW

COMMENT AND ASSESSMENT

Today's OCR decision and assessment did not contain much by way of surprises. The press release was short and to the point. It notes that the economic expansion is modest so far despite strong commodity prices, and recent business confidence has fallen. But earthquake reconstruction is still expected to boost activity and lead to increased pressure on resources. The timing of this is still up in the air, with a mid-2012 timeframe as opposed to anything earlier looking most likely.

Global events are still a key consideration. Bank funding costs, which the RBNZ highlighted to quite an extent in the September *Monetary Policy Statement*, is something they continue to watch very closely. Though the credit default swap spreads of the major Australian banks have come off their recent highs in the last few weeks, in level terms they are still very high. To date there has been no impact on actual borrowing rates via this channel, but the longer the global situation remains uncertain, the more likely we will see some impact come through.

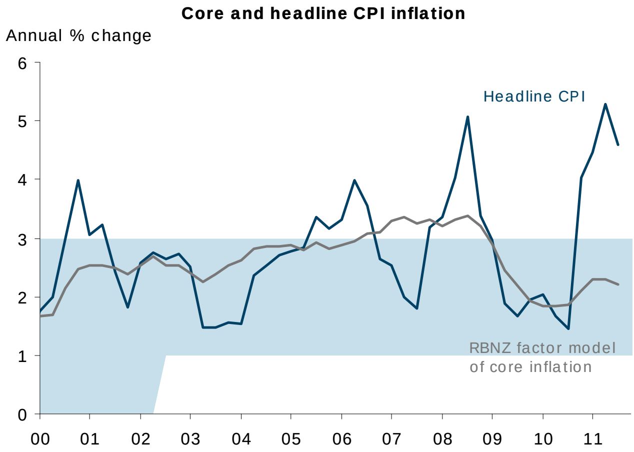


Sources: ANZ, National Bank, Bloomberg

Inflation is not a concern for the RBNZ following the soft Q3 CPI print, where "underlying inflation is settling near 2 percent", which is the mid-point of the RBNZ target band. This leaves the RBNZ more comfortable in keeping the OCR where it is for longer. Indeed, the Bank thinks that pressure on domestic resources will only increase gradually, suggesting that they do not expect to see upward pressure on inflation emerging in the near term.

While they are in no rush, the RBNZ still expects to lift interest rates at some stage. To us, this is predicated on two key assumptions:

- **The first is that global developments have only a mild impact on New Zealand.** Certainly this is the case at present with limited flow-through to commodity prices and confidence in New Zealand, relative to what we have seen in other countries. However, the situation here is very fluid and in the current environment we need to rely increasingly on anecdotes as timely barometers of what is going on. On this front, we are seeing more real time evidence of follow-through. We would not classify it as either "mild" or "severe" at this stage. But it is a reminder of where the risk profile resides.
- **The second assumption is regarding the global scene itself**, where the RBNZ notes that "the European sovereign debt crisis could cause a further slowing in global activity". On this front, we are more wary than the consensus regarding the situation in Europe. We fully expect a relief package that includes an expanded EFSF, bank recapitalisation etc. However, we view sticking points such as the nominal GDP to 10-year bond yield gap in key nations such as Italy, how fiscal integration is achieved, and the political dynamics as serious challenges to a package ultimately holding together. We fully expect that weakness in Europe will flow through into other trading partners.



Sources: ANZ, National Bank, Statistics NZ, RBNZ

IMPLICATIONS

We maintain our view of a mid-2012 OCR increase, but the risk profile is clearly towards a later increase as opposed to sooner. There is no doubt that the Rugby World Cup has provided a welcome stimulus to the economy. But with the event now over, and earthquake reconstruction still some way off, there is uncertainty over how the

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economy will fare up to the period in which earthquake reconstruction steps up. This week's release of the *Pre-Election Economic and Fiscal Update* shows that fiscal policy will remain contractionary over the coming two years, with no scope for any election lolly scramble. As such, monetary policy could end up remaining stimulatory for longer.

OCTOBER OCR REVIEW PRESS RELEASE

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.

Reserve Bank Governor Alan Bollard said: "Domestic activity has continued to expand at only a modest pace despite relatively strong commodity prices. More recently, domestic business confidence has fallen back somewhat. Further ahead, earthquake repairs and reconstruction in Canterbury are still expected to provide significant impetus for demand.

"As foreshadowed at the time of the September Monetary Policy Statement, there is a real risk that the European sovereign debt crisis could cause a further slowing in global activity, putting downward pressure on New Zealand's commodity export prices. The difficult international market conditions could also result in increased New Zealand bank funding costs over the coming year.

"Annual headline CPI inflation continues to be above the Bank's 1 to 3 percent target band. That largely reflects the one-off effect of last year's increase in the rate of GST. September quarter inflation data suggest that, once GST and other one-off influences have passed, underlying inflation is settling near 2 percent.

"Given the ongoing global economic and financial risks, it remains prudent to continue to keep the OCR on hold at 2.5 percent for now. However, if global developments have only a mild impact on the New Zealand economy, it is likely that gradually increasing pressure on domestic resources will require future OCR increases."

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