

Economic Update

RBNZ's reality check

Review of July 29th OCR Review

- RBNZ raises the OCR by 25 basis points to 3.00%, as widely expected.
- Explicitly flags the possibility of a more gradual tightening cycle than implied by its June MPS.
- We continue to expect steady increases in the OCR but acknowledge the greater risk of a pause.

The Official Cash Rate (OCR) increased to 3.00%

The RBNZ increased the OCR by 25 basis points to 3.00%, as widely expected. The comment “the pace and extent of further OCR increases is likely to be more moderate than was projected in the June Statement” was slightly more dovish than markets had been expecting. There was some surprise in the markets at the explicit acknowledgement from the RBNZ that it may pause at some point.

We expect the RBNZ will continue to reduce monetary policy stimulus, and that it will move again by 25 basis points in September. To the extent the June MPS had implied OCR would eventually reach 5.75%, the downward revisions now make its forecasts more realistic. Our core expectation remains for the RBNZ to steadily increase the OCR to 5%, but acknowledge there is the risk of a pause at some point in the cycle.

Growth outlook slightly softer

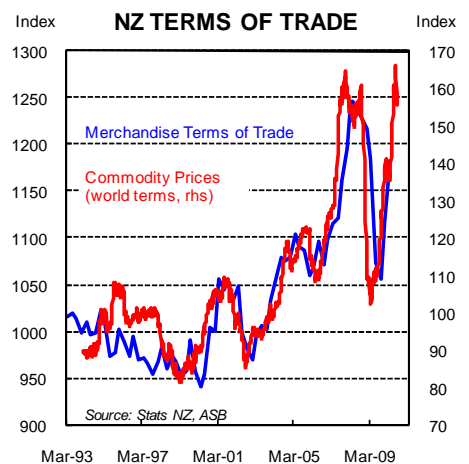
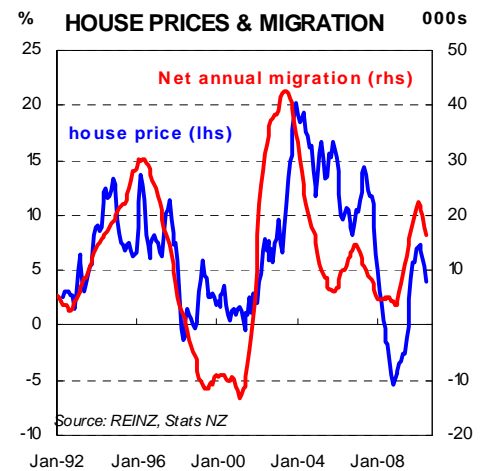
RBNZ revises growth outlook to bring it more in line with consensus.

The RBNZ's economic outlook is slightly softer compared to the June outlook, as expected. Between the June MPS and today, the flow of data has provided the RBNZ with a reality check on its previously optimistic growth forecasts. In contrast to the RBNZ, the recent flow of data has been less of a surprise to us. The Reserve Bank's forecasts have been above the consensus average for some time, and the downward revisions largely reflect the RBNZ moving closer to the consensus view.

The RBNZ highlighted the recent slowing in net migration, which is likely to be contributing to a weaker outlook for consumer spending and the housing market. In addition, the RBNZ has acknowledged the *prospects* for trading partner growth have deteriorated, suggesting some downward revisions to its global growth outlook. In the June MPS, the RBNZ had a very upbeat view on trading partner growth prospects for 2011 and beyond. Given the recent run of softer economic data offshore (in particular signs that Chinese growth is started to slow in response to tighter credit conditions), the strength of the global recovery the RBNZ had factored in was questionable.

Expectation of export-led recovery remains.

Nonetheless, the Bank continues to highlight the high levels of commodity prices, although these have moderated in recent weeks. Despite the downward revisions the RBNZ remains positive on the economic recovery, noting that near-term GDP growth will remain “respectable”, with support from the export sector (in particular manufacturing and forestry).



General Advice Warning

As this report was prepared without taking into account your objectives, financial situation or particular needs, you should not take any action in reliance of this report without considering your particular circumstances and, if necessary, obtaining professional advice.

Attempts to manage inflation expectations.

Inflation outlook

The RBNZ highlighted the boost to headline CPI from the raft of Government policy changes, in particular the GST increase, over the coming year. We forecast these changes will boost annual headline CPI to well above 5% by mid-2011.

The RBNZ reiterated its key assumption that this strong headline result will not spill over to generalised inflation, and notes that it will monitor various inflation indicators for signs of changes to price and wage setting behaviour. In recent months, we have seen a lift in pricing intentions and cost expectations. While this is likely to reflect growing awareness of the high headline CPI over the coming year, it highlights the challenge the RBNZ faces in containing inflation expectations. This is particularly in light of the fact that the RBNZ's own survey of 2 year ahead inflation expectations continues to edge up in recent quarters and is now sitting close to the top of the RBNZ's inflation target of 3%. We continue to see upside risks to the RBNZ's inflation outlook.

Acknowledges risk of a pause at some point in the cycle.

The pace and extent of future OCR increases

One new bit of information was the acknowledgement from the RBNZ that "the pace and extent of further OCR increases is likely to be more moderate than was projected in the June Statement." Based on this statement, the probability of a pause has grown. Our judgment is that the 3.5% mark would be the more probable point should a pause eventuate. At this level the OCR would still be delivering effective interest rates that are still unequivocally stimulatory. Moreover, December gives the RBNZ another few months to assess the strength of the local recovery and the risks hanging around the otherwise sunny global economic outlook, as well as some time to assess the impacts of the GST increase. In the meantime – as always – each individual decision will be driven by how events line up with the RBNZ's outlook.

RBNZ no longer expects OCR to reach 5.75%.

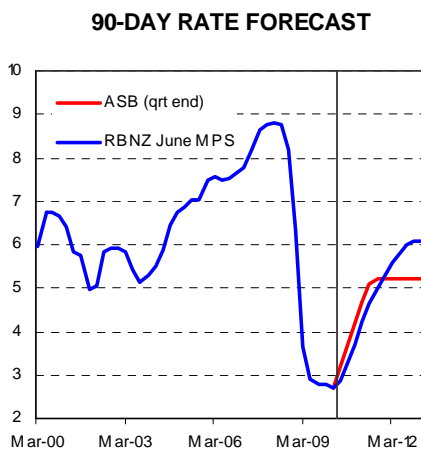
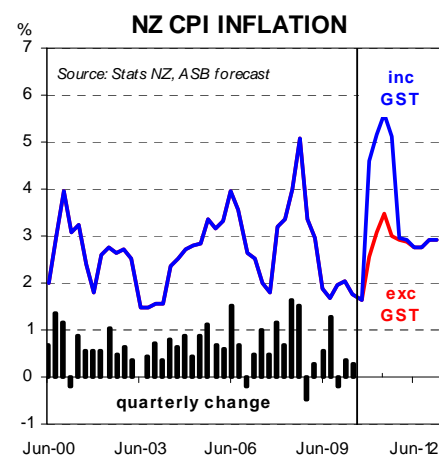
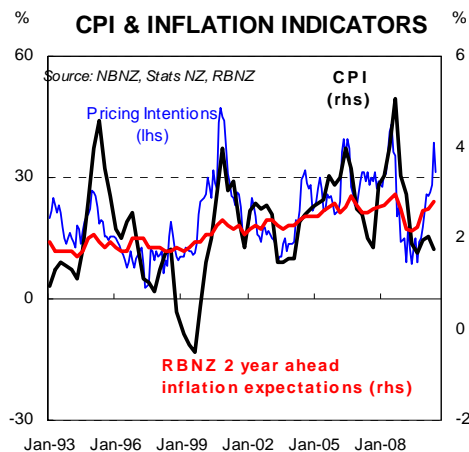
We have been of the view that the OCR would not get as high as the 5.75% mark implied by the RBNZ's June MPS interest rate forecast. Our view is the OCR peak will be 5%, with the risks skewed to a lower peak than that if funding premiums

remain elevated. In part we expect the NZD to remain comparatively firm and do some of the work in containing future inflation. It was evident from the jawboning in today's statement that the RBNZ was uncomfortable with the recent lift in the NZD. Incorporation of a stronger NZD would in itself imply a lower track for the RBNZ's 90-day bank bill outlook.

Implications

Given the economic recovery remains intact and "inflation pressures are expected to pick up", the RBNZ sees some further removal of monetary policy stimulus as appropriate. However, given the growth outlook has softened relative to the RBNZ's previous forecasts, it has questioned the pace and extent of these increases. It pays to bear in mind that the RBNZ did previously have a cash rate of 5.75% implied in its 90-day rate forecasts. Given ongoing funding costs, we never saw a peak this high as realistic. Nonetheless, the words "pace and extent" of OCR increases do bring into question when and if the RBNZ will pause at some point during the cycle.

Continued reduction of monetary policy stimulus expected.



We expect the RBNZ will continue to lift the OCR, and that it will move again by 25bp in September. In spite of the implicit discussion of a pause we have, however, kept to our view that the RBNZ will steadily increase the OCR to 5%. Although the RBNZ has again had to question the optimism of its growth outlook, we are still of the view that the RBNZ's inflation outlook is on the light side. Whether or not economic data soften further prior to the RBNZ reassessing the stubbornness of future inflation will be one key factor in determining if there is a pause. Markets place roughly a 65% change on a September OCR increase, which is a little light but quite reasonable.

Market reaction

NZD and interest rates lower following statement release.

Given the RBNZ's explicit jaw-boning of the NZ dollar lower in the Statement, the NZD/USD fell from 0.7276 just prior to the Statement release to 0.7222 shortly after the release.

Meanwhile, interest rates edged steadily lower, reflecting the RBNZ's explicit acknowledgement it might pause sometime in the cycle. Interest rates fell around 2-8 basis points across the curve in the half hour following the statement release. In particular, the 3-year swap rate fell from 4.43% just prior to the release to 4.36% after the release. Markets are currently pricing in around 65% probability of an OCR increase in the September meeting.

OCR formally reconsidered every 6-7 weeks

Some background to the event

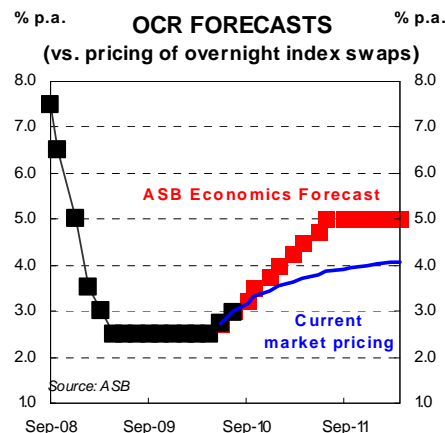
The Reserve Bank of New Zealand (RBNZ) releases a Monetary Policy Statement (MPS) each quarter outlining its thinking about the economy, especially future growth and inflation rates.

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.



RBNZ NEWS RELEASE

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."

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