

Economic Update

Domestic conditions say go

10th June *Monetary Policy Statement* Preview

- We expect the RBNZ to increase the OCR by 25bp on June 10.
- Domestic conditions warrant a rate increase, with evidence of inflation pressures building up.
- But fears of European sovereign debt contagion introduce some uncertainty.

We expect the RBNZ to increase the OCR by 25 basis points at the June *Monetary Policy Statement*. Recent data have provided further evidence that a self-sustaining recovery is taking place. In particular, businesses have become more confident of a recovery in demand, and as such are planning for expansion. This is reflected in the growth in employment over the March quarter.

Furthermore, there are signs of inflation pressures building up. Recent surveys show medium-term inflation expectations continuing to edge close to the top of RBNZ target band of 3%. Added to that, there are a host of government charges over the coming year in the form of tobacco excise taxes, ACC levies, higher energy costs through the implementation of the Emissions Trading Scheme (ETS) and the increase in GST. While these items can be looked through by the RBNZ, the combined factors are expected to push annual headline inflation close to 6% by the middle of next year and will test the RBNZ's key assumption that inflation expectations will remain contained. Moreover, underlying inflation pressures will lift as the economy recovers. Considering domestic conditions in isolation would indicate overwhelmingly that the RBNZ would increase the OCR in the June MPS. However, recent developments in the Euro zone have introduced some uncertainty into this decision. Fears of the sovereign debt crisis in Greece and Spain spreading to other European economies have heightened risk aversion, though there has been a stabilisation in debt markets more recently.

Market pricing now implies an 80% chance of a rate increase in the June meeting. Given the effects of the sovereign debt crisis on NZ have been limited to date, we expect the RBNZ will begin removing monetary policy stimulus at the June MPS.

Inflation pressures have increased

Less slack in the labour market.

Recent developments have in sum lifted our inflation concerns. The Q1 Household Labour Force Survey was much stronger than expected, with the sharp fall in the unemployment rate from 7.1% to 6% indicating much less slack in the labour market. Although wage growth in Q1 was a touch softer than the RBNZ's March MPS forecasts, the stronger employment data suggests future wage growth will be stronger than anticipated.

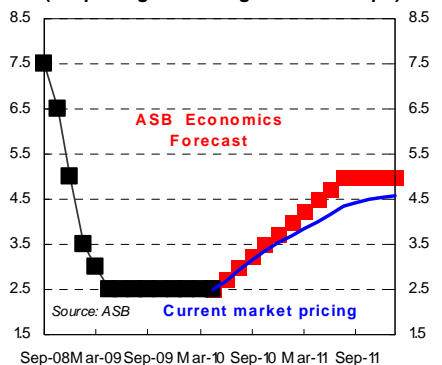
More fiscal stimulus.

Furthermore, Budget 2010 shows fiscal policy being more stimulatory in the short term, as near-term expenditure rises quickly and new revenue-gathering initiatives are slower to kick in. This increased fiscal stimulus suggests monetary policy stimulus should be removed sooner.

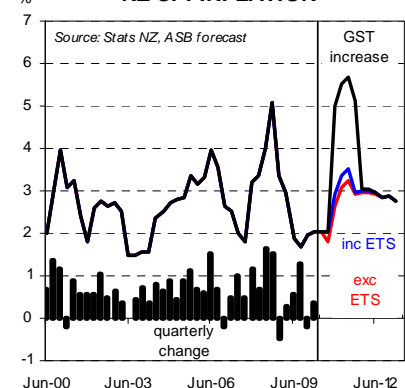
High headline CPI will test assumption that inflation expectations will remain anchored.

We now expect annual CPI inflation to rise to 5.5% in March 2011 and reach a peak of 5.7% by mid-2011. This high headline result will be driven by a range of Government charges, including the increase in tobacco tax, ACC levies, GST and implementation of the Emissions Trading Scheme. The Policy Targets Agreement allows the RBNZ to look through the first-round effects of these factors. However, at a time when two year ahead inflation expectations continue to edge towards the top of the RBNZ's target band of 3%, such a high headline result pose a risk to the RBNZ's key assumption that wage and price setting behaviour will remain unchanged.

OCR FORECASTS (vs. pricing of overnight index swaps)



NZ CPI INFLATION



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.

Fonterra announcement will boost rural confidence.

Developments in commodity prices have been positive, with prices for dairy, beef, and forestry lifting on year-ago levels. In particular, Fonterra's strong payout forecast for next season is a significant development for dairy farmers and will go some way to boost confidence in the rural sector.

Subdued activity in some areas.

Against this backdrop of increased inflation pressures, there are areas where activity remains subdued. House prices are holding up impressively, but low housing turnover indicates continued slowing in housing market momentum. Furthermore, both residential and non-residential consent issuance points to a muted recovery in construction activity.

Meanwhile, credit demand remains weak. The subdued levels of borrowing undertaken by households will be in line with the RBNZ's expectations of a rebalancing in the NZ economy as households rein in their spending. However, the RBNZ has expressed a desire to see a recovery in business credit as businesses look to invest again.

But self-sustaining recovery taking shape.

Nonetheless, it looks as though a self-sustaining recovery is falling into place. Despite the weak level of business credit there have been tentative signs of a rebound in plant and machinery investment, and recent business surveys show a continued improvement in investment and hiring intentions. This indicates that businesses are confident enough about an improvement in demand to plan for expansion.

Developments in Euro zone introduce some uncertainty

Euro zone developments make June decision not so clear-cut.

The inflation and activity outlooks suggest the RBNZ should go ahead with rate hikes. However, with the current uncertainties stemming from the Euro zone the RBNZ's gut feeling may be no.

Increasingly, economists and markets are starting to factor in a weaker growth outlook for economies more directly exposed to the European sovereign debt crisis. Fiscal austerity measures will result in the government sector being a net drag on growth in crisis countries. In addition, these economies will be weighed down by higher debt funding costs. However, what is not yet clear is how the current crisis will transmit to the rest of the global economy and exactly how concerned the RBNZ needs to be.

Potential effects on trading partner growth.

The Euro zone's current problems have the potential to affect NZ in two ways. First is through lower trading partner growth. However, unlike in the US-led financial crisis, few of NZ's trading partners appear to be directly affected. In particular, the US and Asia-Pacific outlook remains robust.

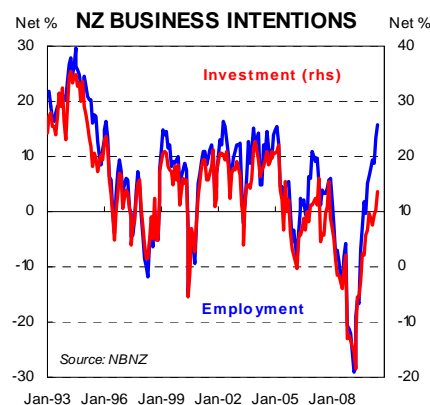
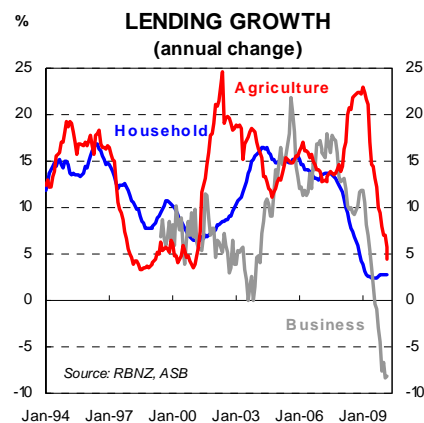
Disruption to credit markets will be concerning.

The larger impact on NZ is likely to come through any disruptions in credit markets, thus affecting liquidity and funding costs. To date, the impact of these has been minimal. Short-term funding spreads have started to lift, but are well below global financial crisis levels. In addition, bank funding costs have not been materially affected to date. If conditions in Europe were to deteriorate and significantly affect NZ liquidity and funding conditions, then the RBNZ would need to rethink its entire gameplan. However, it only remains a risk this deterioration could happen and, when weighing up policy decisions, the RBNZ needs to treat it as such. Currently, the more sensible assumption is that measures by the ECB and EU members will be effective in preventing Round 2 of the global financial crisis.

But this time looks different.

Another key difference between the European crisis and the US-led crisis is there appears to be more discrimination between different debt markets. Underpinning the European debt crisis has been poor fiscal control in a number of EU nations. Lack of fiscal discipline in the 'good times' saw many governments continue to run fiscal deficits and increase debt levels, with little regard to keeping some safety net should the economic outlook and government revenue deteriorate. Worse still, in the case of Greece, previous governments had concealed the true extent of fiscal deficits and total debt. Transgressors are now being singled out.

NZ is (for now) being positively discriminated against. The Fiscal Responsibility Act has exerted discipline on successive NZ governments. Further to that, the NZ Government is seen to be credible in its plan to return the fiscal balance to surplus and as such the NZ government and NZ economy are seen as a far better credit risk and less affected by Europe's surge in government bond yields.



Implications: RBNZ likely to go ahead with OCR increase

Need to act now to control medium-term inflation.

Domestic conditions alone would overwhelmingly point to a 25bp OCR increase in the June MPS. Given interest rates typically take up to two years to fully impact on inflation, central banks need to look ahead and decide on the appropriate monetary policy settings based on upcoming inflation pressures. A host of government charges over the coming year will lift headline inflation. Granted, the expected increase in annual CPI to close to 6% by mid-2011 is largely due to tobacco excise taxes, ACC levies, higher energy costs through the implementation of ETS and the increase in GST. The Policy Targets Agreement allows the RBNZ to look through the first-round effects. However, the fact that annual inflation is expected to rise close to 6% next year when medium-term inflation expectations are already close to the top of the inflation target band pose a very real risk of a change in wage and price setting behaviour. It is this risk of unanchoring inflation expectations – on top of an underlying lift in inflation pressures – which the RBNZ needs to heed more.

Furthermore, the release of the Budget on May 20 eliminated a key uncertainty in domestic conditions. The removal of the ability to claim depreciation on most buildings including rental and commercial properties is helpful for monetary policy in the medium term. However, there is actually more fiscal stimulus in the economy over the coming year via the sequencing of policy changes. Against the backdrop of a self-sustaining recovery, the RBNZ will need to act in a timely manner to contain these stronger inflation pressures.

Hence, a June rate increase would be clear-cut if not for the recent developments in the European region. Concerns that the European debt crisis will make accessing offshore funds difficult and lower demand for NZ's exports have introduced some uncertainty into the June rate decision. Nonetheless, given the effects on the NZ economy to date have been limited, we expect the RBNZ will go ahead with reducing monetary policy stimulus at the June MPS.

Potential for a pause in the tightening cycle given increased uncertainty.

Beyond the decision over the timing of the OCR increase is the amount of further increases that will follow over the coming year. Given the higher degree of uncertainty over how the economic recovery will now evolve there is the potential for the RBNZ to pause at some point in its tightening cycle. How the RBNZ weighs up the stronger domestic outlook with the tighter credit conditions in European markets will provide some insight into the extent and pace at which monetary policy stimulus will be removed. Markets look to be erring on the side of some risk of a pause during the tightening cycle. As we currently see a greater chance of a pause from the RBNZ than 50bp rate rises that stance seems appropriate.

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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