

### 11<sup>th</sup> March MPS Preview

- RBNZ to keep cash rate on hold at 2.5%, no significant change in tone likely.
- Recent developments have softened the upside risks to economic outlook.
- But building inflation pressures mean RBNZ will need to hike in June.

We expect the RBNZ to remain on hold at the March MPS. The economic outlook continues to evolve broadly in line with the December *Monetary Policy Statement* forecasts and we expect revisions to the forecasts to be minor. However, the upside risks to the outlook have softened since December. Labour market and inflation data was on the weak side of expectations, reducing the urgency to lift rates from emergency settings. The housing market is rapidly losing momentum aided by the increasing likelihood tax advantages for property investment will be reduced. In addition, there are increased concerns on the sustainability of the global recovery over 2010. China is looking to slow its own economy and the current situation in Europe has heightened concerns. Reflecting these wobbles, the recovery in NZ commodity prices has stalled. The Reserve Bank is likely to remain comfortable with its "middle of 2010" outlook for rate hikes. We expect the RBNZ will commence tightening at the June meeting, with 25 basis point OCR increases at each meeting until July 2011.

#### Global jitters

*Greece concerns still front-brain*

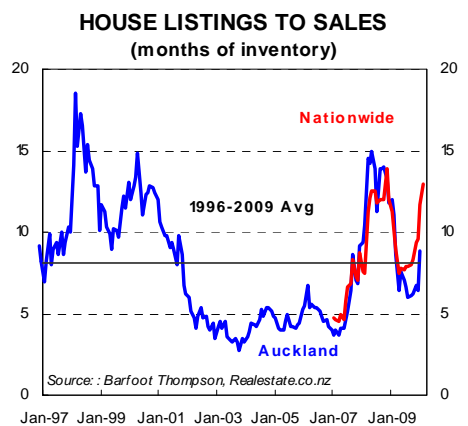
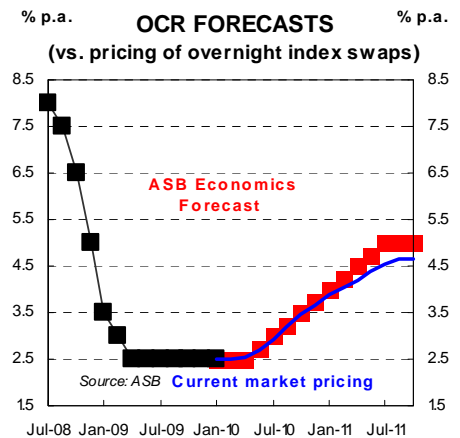
Confidence in the strength of the global recovery has wavered over recent weeks. Greece has drawn attention to the fragility of the euro area, particularly the uncomfortably high levels of government debt post financial crisis. In the US, recent weakness in the housing market has highlighted the economy's continued dependence on fiscal and monetary support, with the sustainability of the former also being questioned in light of increased focus on the government debt levels. Closer to home, China has taken further steps to cool its own economy. At this stage developments are unlikely to significantly alter world growth forecasts, but do underpin a shift in risks. Growing concerns have been reflected in the softening of commodity prices. With the recovery in NZ commodity prices stalling, it may be enough to see the RBNZ question the strength of recovery forecasted for 2010.

#### Housing market running out of steam

*Data points to slowing in housing market momentum*

Recent housing data indicate the puff is coming out of the housing market, with a fall in house sales, rebound in days to sell and signs that more listings are coming on board. In addition, our survey of housing confidence shows a slight softening in positive sentiment.

The recent increase in mortgage rates, along with the expectations of further rate increases in the near future, are likely to be contributing to cooler demand.



#### 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.

*Uncertainty over tax changes also weighing*

Added to this, real estate agents noted recently the increased uncertainty within the market following the Tax Working Group's (TWG) recommendation to change the tax treatment around housing investment. Two potential options are remaining: removing the ability to claim depreciation (recommended by the TWG); or ring-fencing tax losses from property so they cannot be used to offset other sources of income. The lack of complete clarity over what the Government will do means the market will continue to be weighed down by uncertainty until the end of May, and could see reduced house sales and price pressures over the next few months.

*Credit growth remains subdued*

This slowing in housing market momentum is reflected in subdued housing credit growth, which will be of comfort to the RBNZ. Meanwhile, consumer credit growth remains weak, indicating households remain cautious about funding their spending through debt against the backdrop of a weak labour market. The latest retail sales data point to the pace of recovery in household spending being very gradual.

Business credit growth remains very weak in line with the low levels of business investment. Improving demand has underpinned some recovery in business confidence, and there are tentative signs of intentions to invest and hire again. As such, we expect business investment and employment to recover over the coming year.

**Inflation – tame for now**

*Inflation pressures will build up over the coming year*

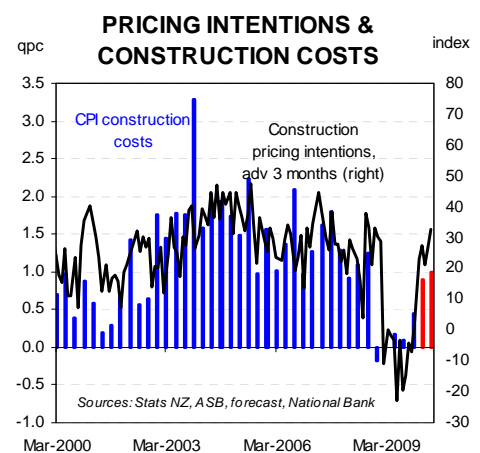
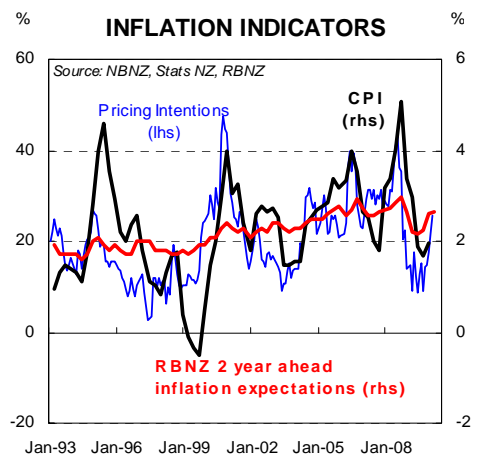
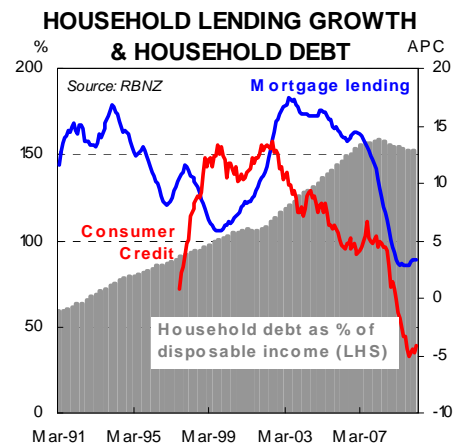
While headline Q4 inflation came in on RBNZ expectations, non-tradable inflation was below expectations. Combined with weak wage growth in the December quarter, inflation pressures look to be subdued in the near-term. However, more timely data point to a building up of inflation pressures over the medium term. In particular, RBNZ 2 year-ahead inflation expectations continued to tick up in the March quarter, to 2.7%. Furthermore, construction costs – which the RBNZ noted held up surprisingly stubbornly against the sharp contraction in construction activity – looks likely to rebound given the increase in pricing intentions in the building industry. Exacerbating this will be the high wages being paid for semi-skilled workers on resource projects in Australia, which will likely encourage emigration of labourers to the mineral-rich country.

Nonetheless, as our view of medium-term inflation pressures appears to be stronger than that of the RBNZ, we expect it to reiterate for now its expectations CPI inflation will track 'comfortably' within the band over the medium term.

**Fiscal consolidation**

*RBNZ will expect Government to play its part*

The RBNZ has explicitly noted the role for fiscal consolidation in the past two statements, and we expect this message to remain until the Budget. The probable change in tax mix (higher taxes on property and consumption, lower taxes on income) is likely to promote increased savings (or less debt accumulation) and be helpful in returning balance to the NZ economy and make monetary policy more effective. However, the RBNZ is also looking for a prompt return of the 'fiscal impulse' to contractionary settings. Alan Bollard has previously noted that fiscal consolidation would allow for interest rates, and quite likely the exchange



rate, to be at a lower setting than would otherwise be the case. Certainly it would be the RBNZ's preference, should the economy be weaker than expected, for interest rates to be on hold for longer rather than interest rates having to be hiked earlier or faster if fiscal settings remain too stimulatory. The RBNZ is sending a very clear message to the Government, and will be watching the Budget very closely to see if fiscal policy will lend monetary policy a helping hand.

### Meaty chunks may cause indigestion

The recent weakness in data (in particular the turn-around in the housing market) has seen us change our view of the first rate hike from April to June. In addition, the pace of tightening need not be as aggressive as we previously thought. Funding costs have introduced a wedge between the OCR and retail interest rates. Combined with an economy more sensitive to interest rates increases, early OCR hikes are likely to have a powerful punch. 'Meaty chunks' (hikes larger than 25 basis points) might cause indigestion.

### Implications

*Slightly softer assessment of NZ economy*

We expect a similar though slightly more cautious statement compared to January. The key change will be in the softer assessment of the NZ economy, in particular the turn in the housing market. The outlook for consumer spending is likely to remain 'subdued'. The RBNZ could possibly express increased concern on the weakness in credit growth (particularly business credit). The RBNZ is likely to note the current uncertainty in global economies and the softening in commodity prices. However, as the RBNZ has always kept a tone of caution, this message is unlikely to be substantially different. The RBNZ's projections of the 90-day rate are likely to continue implying a Q3 start to the tightening cycle.

The market expects a relatively cautious statement, and the risk for the RBNZ is not accounting for the dramatic shift in current market sentiment over recent weeks. To the extent markets now see reduced upside risks, continued references to positive developments may potentially be perceived as overly upbeat. The RBNZ is likely to be relatively happy with current market pricing and would be reluctant to rock the boat significantly. Pricing is currently consistent with our expectation of a 25bp hike per meeting, starting in June.

### 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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