



Review of March 11th Monetary Policy Statement

- The OCR remains on hold at 2.5%, ‘middle of 2010’ assessment for rate hikes unchanged.
- RBNZ lowers peak in 90-day track as bank funding costs likely to persist.
- We continue to expect the RBNZ to hike 25bp in June, as inflation outlook less comfortable.

The Official Cash Rate (OCR) on hold at 2.5%

The RBNZ left the OCR unchanged as expected. The RBNZ stuck with its middle of 2010 assessment for rate hikes, but provided no further clues if it is thinking June or July for the first increase, with no softening in tone from the RBNZ. The RBNZ left its near-term projection for the 90-day interest rate unchanged. However, the RBNZ did lower its medium-term 90-day track in recognition that current bank funding costs were likely to persist. Given this, we believe the RBNZ’s view of the neutral OCR is around 100-150 basis points lower than pre-crisis levels. In addition, we believe the RBNZ base case for rate hikes will not be meaty chunks; i.e rate hikes are likely to be 25 basis point steps.

The RBNZ has revised up its inflation forecasts, mostly due to higher than usual ACC levies. The RBNZ is no longer ‘comfortable’ with the inflation outlook. The combination of one-offs (ETS, ACC, GST) is likely to test the RBNZ’s assumption that inflation expectations will remain anchored.

We continue to expect the RBNZ to begin lifting rates in June. An important factor of timing is that the RBNZ has not softened its tone despite factors such as a slowing housing market. The RBNZ did in our view provide a little more clarity over the likely magnitude of OCR hikes: they are most likely to be 25bp steps unless the inflation outlook starts to change markedly.

[Link to RBNZ MPS](#)

RBNZ lowers medium-term 90-day forecast

Bank funding costs lowers OCR outlook

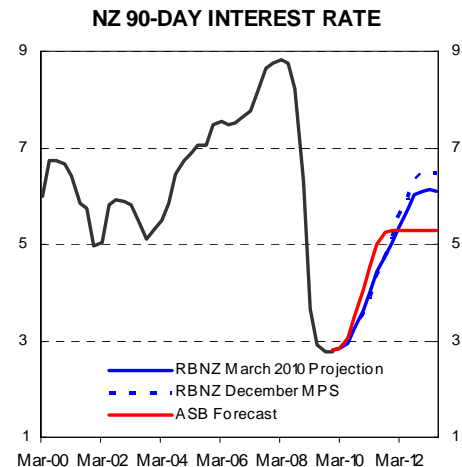
The RBNZ has lowered the longer-term outlook for the 90-day track. The Bank now assumes that bank funding costs will remain elevated, which reduces the amount of stimulus normally associated with a given level of the OCR. The Bank notes that this will reduce the extent of future increases in the OCR (supported by the lower 90-day track). Overall, looking at its assumption for bank funding costs we think the RBNZ’s view of the neutral OCR is roughly 100-150 basis points lower than pre-crisis levels. This is similar to our own assessment of around 125 basis points (see [Finding Neutral](#)). In addition, we believe the RBNZ base case for rate hikes will not be meaty chunks; i.e rate hikes are likely to be 25 basis point steps.

Suggesting lower view on neutral OCR

Inflation revised up on higher ACC levies

Inflation gets less comfortable

A change in the RBNZ’s statement is that it no longer feels ‘comfortable’ on the inflation outlook. The inflation track has been revised higher, mostly on revised expectations for higher ACC levies.



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.

Series of one-offs will push inflation higher

Increased upside risks to underlying inflation

Little room to tolerate upside surprises

Growth outlook unchanged

Although the RBNZ excludes the first-round effects of the Emissions Trading Scheme on inflation when setting monetary policy (which is expected to add about 0.4% to headline CPI inflation in the year to June 2011), it notes that the combination of the ETS and ACC charges will push headline inflation toward the top of the target range. Once it includes the impact of a GST increase, we expect the RBNZ will become increasingly uncomfortable with the upside risks to underlying inflation. The RBNZ is assuming that inflation expectations will remain anchored, but this series of one-off events poses a risk to this assumption. Indeed, the inflation outlook gained more discussion than has previously been the case, perhaps suggesting some increased concern in this area. With 2 year ahead inflation expectations already elevated at 2.7% and an increase in pricing intentions in recent months, there is little room for further upside inflation surprises. The RBNZ is assuming that inflation expectations will remain anchored, but this series of one-off events poses a risk to this assumption.

Upside risks to inflation outlook concerning

Despite the upward revision, we still see some upside risk to the RBNZ's inflation forecasts particularly in the near term. The increase in pricing intentions in the construction sector in recent months point to a rebound in construction costs, which we expect to be a key driver in the rebound in non-tradable inflation. In contrast, the RBNZ is forecasting a relatively muted rebound in non-tradable inflation from Q4's surprisingly weak number. Furthermore, the RBNZ is expecting the depreciation in the NZ dollar over the second half of 2009 to lead to a further decline in tradable inflation. While we expect weak household demand to place downward pressure on the retail prices for recreational items, this will be offset by increases in petrol prices. Just this week, petrol prices rose to the highest level in 18 months. With the RBNZ already projecting inflation to rise to close to the top of the target band, any upside surprises will be concerning.

Growth outlook unchanged

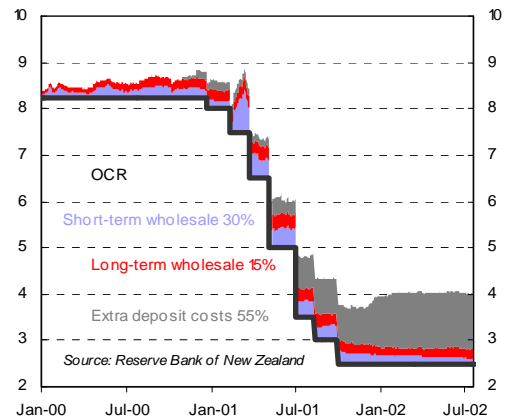
The RBNZ's growth outlook was broadly unchanged from December, as expected, with just some minor tweaks in the composition. Consumption is slightly higher, while the recovery in business investment has been pushed back. The RBNZ has discounted the recent strength in headline business confidence, pointing to relatively soft intentions at this stage of the recovery. Overall, the RBNZ is putting weight on very conservative credit growth in both the business and household sectors.

On the global front, trading partner growth has been revised higher due to stronger than expected growth from Asia. However, the RBNZ noted an increase in the downside risks. In particular, the sustainability of growth as fiscal stimulus is withdrawn and the risk of some economies failing to meet their sovereign debt obligations.

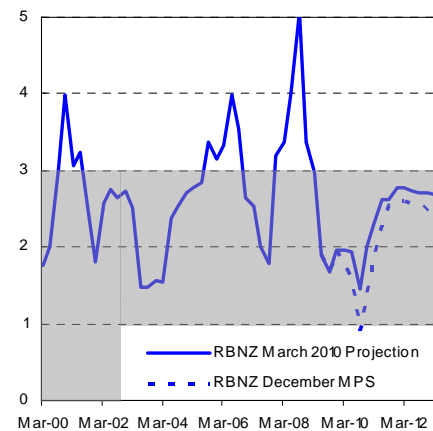
Fiscal restraint

With the Government budget looming in May, the RBNZ continue to push the need for fiscal consolidation to help do some of the work for monetary policy. The Bank explicitly notes that fiscal restraint beyond that described in *Budget 2009* would be welcome.

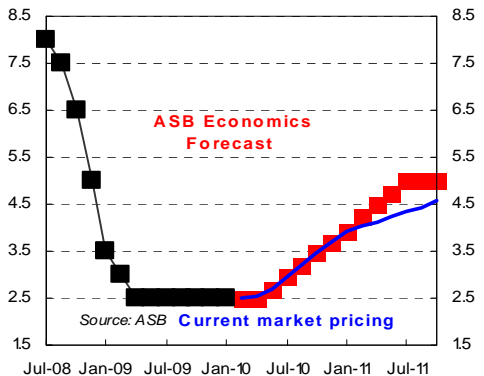
MARGINAL BANK FUNDING COSTS RELATIVE TO THE OCR



RBNZ CPI INFLATION FORECASTS



OCR FORECASTS (vs. pricing of overnight index swaps)



Higher bank funding costs reduce neutral OCR

Impacts on neutral policy rate

A subtle but important acknowledgement from the RBNZ is the likely impact on the OCR of bank funding costs. As we recently published ([Finding Neutral](#)), we expect that shifts in bank funding costs relative to the OCR in the wake of the credit crisis and RBNZ liquidity policy are likely to endure. The RBNZ has now also explicitly acknowledged that the wedge between bank funding costs and the OCR (which it estimates is currently around 150bp) is likely to remain in the foreseeable future. In other words the level the OCR needs to sit at to achieve a given household/business borrowing rate is now that much lower. Just how large that funding wedge remains will depend on the future state of global credit markets and on the longer-term relationship between the OCR and retail deposit rates.

Our assessment of the new 'neutral' level of the OCR (i.e. at which level interest rates are neither boosting nor constraining the economy) is 5%, taking into account the impact of bank funding costs. The RBNZ likely has a very similar view. The implication is that the OCR will not have nearly as far to rise as would be the case if pre-crisis financial conditions prevailed in order to remove the current interest rate stimulus. The RBNZ interest rate outlook explicitly reflects this.

Borrowers behaviour may also reduce neutral OCR

One uncertainty is the level of household/business borrowing rates that is roughly neutral for the economy could also be lower. To the extent that there is a lasting impact on borrowers' appetites, the neutral OCR would also be that much lower – on top of the funding impact. It is far too soon to assess if there will be a lasting change in borrowers' behaviour. Both the RBNZ and ourselves are assuming for now that there will be no lasting change in the neutral rate that borrowers pay. But the potential for change raises the possibility that the neutral OCR level could be even lower than the wedge between the OCR and bank rates alone implies.

Early hikes likely to be powerful

RBNZ has also noted the extent to which the duration of mortgage fixed terms is shortening, and has explicitly said it expects that both that and the changes in bank funding costs will mean future tightening has "quite a powerful and relatively immediate impact".

Small 25bp steps likely

All of the above factors/uncertainties reinforce that the OCR peak is likely to be comparatively low, and that the more likely magnitude of OCR hikes is 25bp. Our outlook for the OCR has a steady series of 25bp OCR increases, which delivers a slightly swifter tightening cycle than the RBNZ's forecasts imply (let alone a tightening cycle with 'meaty chunks'). However, we also expect the eventual stopping point will be slightly lower.

Implications:

RBNZ sticks with "middle of 2010".

The RBNZ gave no real fresh clues as to the likely starting point of the tightening cycle. The "middle of 2010" phrasing remains; the economic growth outlook was similar; inflation – once removing the direct effects of higher ACC increases – was also roughly the same. However, with inflation excluding a string of likely one-off factors sitting in the top half of the target band, the RBNZ's degree of calm over medium-term inflation has one-way (upside) risk. Although the RBNZ's 90-day track remains more consistent with a Q3 OCR hike, we still see June as more likely. An important factor of timing is that the RBNZ has not softened its tone despite factors such as a slowing housing market.

The RBNZ did in our view provide a little more clarity over the likely magnitude of OCR hikes: they are most likely to be 25bp steps unless the inflation outlook starts to change markedly. Larger hikes than 25bp have not been ruled out and the RBNZ will stick with 25bp moves until events suggest larger hikes are warranted. The discussion of immediate impact of OCR hikes on lending rates and an acknowledgement that banks' funding cost wedge relative to the OCR will remain imply 25bp is the likely option initially.

We still expect 25bp in June.

We hold to our view that June is the more likely timing within a June-July window, and are a little more confident that the RBNZ's base case for OCR increases is 25bp moves. Market pricing is consistent with this tightening profile: the main question for markets is less about the magnitude and more about the exact start date.

Market Reaction

The mood in FX markets overnight was buoyant in London afternoon FX trade, with the NZD pressing up towards 0.71 in New York trade. NZD came off that NY peak going into the RBNZ announcement, slipping from a high around 0.709 at 5am, to 0.706 at 9am. The NZD dipped to 0.703 immediately after the RBNZ announcement, and got as low as 0.701 in morning trade.

	8.30am	9.10am	11.30am
NZD/USD	0.7065	0.7035	0.7018
NZD/AUD	0.7717	0.7698	0.7668
NZD/EUR	0.5171	0.5154	0.5139
NZD/JPY	63.97	63.66	63.52
NZD/GBP	0.4719	0.4703	0.4684
AUD/USD	0.9156	0.915	0.9152
90 day BB	2.69	2.69	2.7
1yr swap	3.45	3.39	3.42
3yr swap	4.64	4.61	4.61
5yr swap	5.16	5.13	5.13

At the time of writing the kiwi had picked up slightly from the morning's low, trading around 0.702 against the USD. The NZD also dipped against the AUD, dropping around ½ a cent from the 0.772 level just prior to the RBNZ announcement, now trading around 0.767. On both crosses the NZD remains above last week's lows, and looks set to remain trading within the recent ranges of 0.69-0.71 against the USD, and 0.76 to 0.78 against the AUD. The focus now shifts back across the Tasman, where the latest employment report is due this afternoon.

Interest rates have eased slightly in the wake of the RBNZ announcement, with swap rates coming down 2-3 basis points across the curve. Pricing of overnight index swaps have eased, and the market no longer has a rate hike fully priced for the June meeting. Pricing is suggesting the OCR will be around 1.5% higher by March 2011.

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.

RBNZ NEWS RELEASE

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

Reserve Bank Governor Alan Bollard said: "The New Zealand economy is recovering broadly as expected and growth is predicted to pick-up further through 2010.

"Trading partner activity has recovered a little faster than expected. Currently, growth is strongest in China, Australia, and emerging Asia, but is much more muted in other trading partners. At the same time, risks around the global outlook have increased, although not to the extreme levels seen at the height of the crisis.

"We estimate the New Zealand economy grew at a stronger pace in the December and March quarters than in the prior two quarters. Looking forward, while growth is expected to increase to about 4 percent next year, this is subdued relative to previous recoveries.

"Policy stimulus and improved consumer confidence have seen a pick-up in household spending. That said, households are still cautious with house sales and credit growth remaining subdued. Business spending is weak despite much improved confidence.

"Annual CPI inflation is currently at 2 percent, and is expected to track within the target range over the medium term. In the short term, implementation of the amended Emissions Trading Scheme and increases in ACC charges will push CPI inflation toward the top of the target range.

"Higher bank funding costs have reduced the level of stimulus that would normally be associated with any given level of the OCR. We expect these costs to persist over the projection reducing the extent of future increases in the OCR. Fiscal consolidation would also help reduce the work that monetary policy might otherwise need to do.

"We continue to expect to begin removing policy stimulus around the middle of 2010."

<http://reports.asb.co.nz/index.html>

ASB ECONOMICS & RESEARCH		PHONE	FAX
Economics			
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 374 8604
ASB Economist	Jane Turner	jane.turner@asb.co.nz	(649) 374 8185
ASB Economist	Christina Leung	christina.leung@asb.co.nz	(649) 369 4421
CBA NZ Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 374 8819

DISCLAIMER

Views expressed in this report are those of the authors as at the date of this report and are based on information and sources believed but not warranted to be correct. Any views or information, while given in good faith, do not necessarily reflect the views of ASB and are subject to change without notice. Neither ASB Bank Limited nor any person involved in preparing this report accepts any liability for any loss or damage whatsoever that may directly or indirectly result from any views, information or omission contained in this report.