

Pluses and minuses

June MPS Preview: OCR on hold at 2.50%

- **New Zealand's economic recovery has been surprisingly robust over the last few months, even overcoming the impact of a second major earthquake.**
- **Commodity exports are helping to lift confidence and activity, and concerns about inflation are emerging again.**
- **However, the RBNZ will be weighing these positive signs against some clear negatives: a cooling world economy, a tighter than expected Budget, and an exchange rate at new highs.**
- **We expect little change in the RBNZ's interest rate projections, with no hikes signalled before 2012.**

The New Zealand economy has had a surprisingly strong run in recent months – and the market knows it. Interest rates and the exchange rate have been gaining against the rest of the world, and opinion is swinging towards the Reserve Bank having to reverse its ‘insurance’ OCR cut earlier than expected.

While we were among the first to herald the strengthening economy, we suspect that Thursday's Monetary Policy Statement will push back on the possibility of early rate hikes. The patchwork of positive signs for growth has to be weighed against some very concrete negatives compared to the RBNZ's last set of projections.

Recent developments

The 50 basis point cut to the OCR in March was intended to soften the direct blow of the Canterbury earthquake, and to head off the risk of a more widespread drop in confidence and activity. At this point it's fair to say “mission accomplished”: business confidence has bounced sharply after the expected post-quake plunge, and is now closer to the levels seen in late 2009/early 2010. Disruptions to activity in Christchurch will continue for some time, but a strong bounce in house sales and retail spending in April suggest that the city is quickly adapting.

Commodity exports remain a shining light for the local economy. World prices have continued to set new highs,

leading to a 27-year high in the March quarter terms of trade and a record trade surplus in April. There are signs that this export income is starting to filter through into on-farm investment and rural land sales.

Stronger than expected activity wouldn't be a concern for the RBNZ, as long as it was comfortable that the weak starting point for the economy would keep wage- and price-setting behaviour well contained. But both the RBNZ survey of expectations and the National Bank business confidence survey found a sharp rise in inflation expectations in May – and in the latter case, a growing number of firms planning to raise their prices. Admittedly, both surveys were held just after fuel prices had leapt to new record highs; a 7% fall in prices since then suggests that not all of the jump in expectations will endure. But the point remains that inflation expectations don't appear to be as well-anchored as the RBNZ has been counting on.

These positives are well-recognised, but there is an element of uncertainty around all of them. Export income is rising, but it's not clear how quickly this will filter through to the wider economy; business confidence doesn't always translate well into hard activity; inflation expectations are up, but the crux is whether people are able to act on them.

In contrast, there's little doubt around the negative influences since the last OCR review. Activity has clearly slowed among our major trading partners, as China has hit the brakes, the US recovery has remained patchy, Japan's natural disasters have disrupted the global manufacturing supply chain, Australia has grappled with floods and tight monetary policy, and Europe's sovereign debt woes have dragged on. The RBNZ's world growth forecasts have tended to be below-consensus and they are likely to be scaled back further this time.

Secondly, the Budget was much tighter than was expected back in March, and will provide a small but noticeable drag on the pace of growth in coming years. We've shaved back our growth forecasts since the Budget, and the RBNZ –

which was picking peak GDP growth of 5.4%, compared to the Treasury's more recent estimate of 4.0% – will certainly be doing the same.

Lastly – and what is likely to receive the most attention – the exchange rate has reached new post-float highs against the US dollar, and while the trade-weighted index is still some way short of its previous highs, it is well north of what the RBNZ would have assumed. At these levels, the exchange rate is doing much of the work needed to contain inflation in the face of a positive commodity price shock.

Projections

In some respects it's difficult to judge how the RBNZ's forecasts will have changed since March, as it only produced a cut-down version of the MPS given the high degree of uncertainty following the February earthquake. In terms of the main details, we expect a slightly smoother GDP growth track compared to March, with stronger near-term prospects, but a lower peak growth rate in 2012/13 as the tighter fiscal stance kicks in. An upward shift in the exchange rate track will help to dampen price pressures, with inflation likely to remain well within the 1-3% target band over the forecast horizon.

Crucially, the balance of developments since March suggests little change to the RBNZ's interest rate projections – this may come as a surprise to the market, which has been increasingly focusing on the potential for a more 'hawkish' tone to the statement. We expect the 90-day rate projections to be consistent with no change in the OCR this year, then a steady tightening through 2012 as the rebuild of Christchurch soaks up the economy's spare capacity, reaching what the RBNZ regards as a 'neutral' level of around 4.5%.

Statement

A few weeks ago RBNZ Governor Bollard wrote an editorial that clearly spelled out how monetary policy would respond to the Canterbury earthquake and the subsequent recovery; we don't see a need to reinvent the wheel when it comes to the wording of this week's statement. The key quote was:

"It is appropriate for monetary policy to remain supportive, given the continued downside risks to economic activity stemming from the Canterbury earthquakes and more broad fragility in the New Zealand economy. It is likely that the OCR remains on hold until these downside risks pass and the economy begins to recover."

It's worth noting that, in contrast to previous statements, this seems to de-link the timing of rate hikes from the Christchurch reconstruction, which would at least open the door for a rate hike before year-end. Indeed, you could

argue that those last two conditions have already been met: the downside risks from the quake have dissipated and the economy is recovering. All the same, we don't think the RBNZ will be rushed into tightening; as much growth as we've seen already, the RBNZ will probably want to see much more before it's satisfied that the economy is no longer 'fragile'.

The statement is likely to address the rise in inflation expectations. Until now the RBNZ has been able to rely on the fact that expectations have been well-contained during a spike in headline inflation, consistent with a lack of pricing power in an economy running well below capacity. The latest expectations surveys, though perhaps overly influenced by recent price movements, are too serious a challenge for the RBNZ to dismiss.

However, against this, the statement is likely to place a heavy focus on the recent rise in the NZD to new post-float highs. It may even describe the currency as "extreme" and "unjustified", two of the given conditions for intervention. Whether or not the RBNZ is preparing to intervene is largely irrelevant – it's been repeatedly shown that intervention has no lasting impact – but such a statement would at least demonstrate how much weight the strong exchange rate carries in the RBNZ's interest rate decisions.

Market implications

Interest rate markets are currently pricing an 80% chance of an OCR hike by December, and a total of 60bps of tightening by mid-2012. We expect the interest rate projections in this week's MPS to be similar to those in March, dampening hopes of any substantial tightening before the reconstruction begins. This should see wholesale interest rates fall, but not by a huge amount – the market and the RBNZ are still in broad agreement about how much rates will need to rise next year, once the rebuild is under way.

A statement endorsing an earlier tightening than was signalled in March would push up interest rates by around 10bps, and may help to lift the exchange rate to fresh highs – for that reason, we view this as the less likely outcome.

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