

# World in disunion

## October 27 OCR preview: RBNZ on hold at 2.50%

- We expect a market-neutral tone from the Reserve Bank next week, reiterating that global risks are keeping the OCR on hold for now.
- Economic conditions have softened on balance since September, but probably not enough to warrant an explicit change to the OCR track at this stage.
- How overseas funding costs evolve will be a crucial factor in the timing and extent of OCR hikes.

### Summary

We think the RBNZ will aim for a broadly neutral tone to next Thursday's OCR review statement. Longer term, the plan is still for higher interest rates to absorb a persistently stronger terms of trade and the resource pressures that will be generated by the rebuild of Christchurch. But the risks around global growth and financial conditions will again favour a cautious approach on interest rates for now. In the September Monetary Policy Statement, the RBNZ projected interest rates to start rising around March next year. Since then the balance of economic conditions has softened, but probably not enough to prompt the RBNZ to signal a later start just yet.

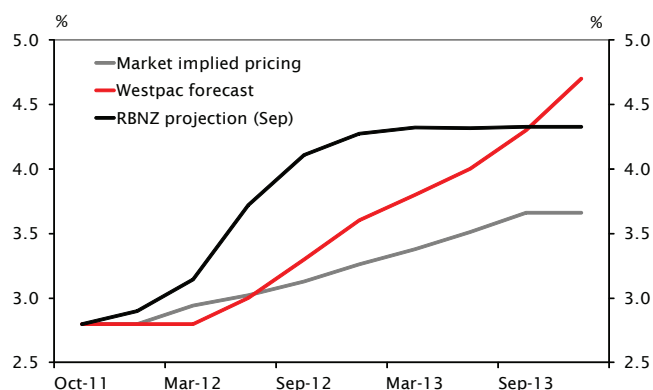
That said, we've moved our call for the first OCR hike out to June, with a more gradual pace of tightening than what the RBNZ projected in September (though we still expect a higher peak in later years). This divergence is nothing new; our view on global growth has been weaker than the market consensus or the RBNZ for some time, and as a result we've tended to be towards the later end of the range of forecasts for the timing of the next hike.

### Details

The New Zealand economy is still performing relatively well against its peers, but there have been signs of softening recently, and it's certainly not "surprising on the upside" in the way it was a few months ago. June quarter GDP grew just 0.1% – against the run of play of the indicators for that quarter – and September quarter growth is currently shaping up as something less than the RBNZ's forecast of 0.8%. At least some of the Q3 softness could be attributed to disruptions and displacement caused by the Rugby World Cup.

In terms of inflation, the September quarter figures will be released on Tuesday, in time for the OCR review. Annual inflation is widely expected to edge back to around 5%, still a very high

90-day rate expectations



level that partly reflects the impact of last year's GST hike. In the last two OCR reviews the RBNZ has been able to fall back on its preferred measure of 'core' inflation, which was relatively well-behaved at 2.3% in the year to June. We'll find out next week whether that remains the case.

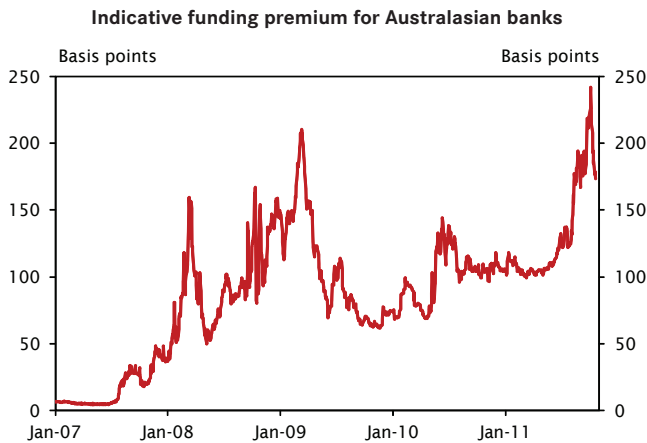
The RBNZ will remain wary of the inflation pressures that will be generated by the Christchurch rebuild over coming years – something that Governor Bollard reiterated in a speech earlier this week, in case the market had taken its eye off this ball. The crucial issue in terms of inflation is not the total size of the reconstruction job – which is now estimated at \$20bn or more – nor the timing of when it begins in earnest, but the speed at which activity ramps up and starts to run into capacity constraints. That's something we'll discover next year.

In September the RBNZ noted "a real risk that global economic activity slows sharply". That risk now seems a little closer to being realised. Recent data has been notably softer in Europe, Asia and Australia (though it has improved a little in the US). In the last two months, Consensus forecasts for growth in our major trading partners have been revised down from 4.5% to 4.0% for next year – though that's still an acceleration on the 3.3% growth expected for this year. We suspect there are more downgrades to come; our forecast is for 3.1% growth in each of those years, including a return to recession for Europe in 2012.

One of the most troubling aspects of global developments has been the tightening in credit markets, which has manifested here

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as a sharp rise in the risk premium that banks and corporates pay for overseas funding. This premium spiked higher in September as fears about a messy end to the European sovereign debt crisis reached a crescendo. However, New Zealand's banks are sufficiently funded and haven't been obligated to borrow at those peak rates, and more recently the premium has started to ease back – something that was a condition of the RBNZ's September forecasts.

Indeed, it's worth noting that the funding premium is now slightly lower than it was at the time of the September MPS. Benchmark swap rates are also about 10 basis points lower, and the New Zealand dollar is about 3 cents lower against the US dollar. So altogether there's been a small easing in financial conditions since the September review, providing some offset to the softening in the global economy.

### Statement and market implications

The balance of developments since September suggests a slightly lower interest rate profile compared to the MPS; the question is whether it's large enough to warrant an explicit statement from the RBNZ to guide the market towards a delay in tightening. We suspect not – interest rate markets are already pricing in a much lower OCR track than the RBNZ has signalled, with no hikes until around July next year. This has provided a de facto easing in financial conditions, to balance out the tensions in global credit markets. If the RBNZ is comfortable with where retail lending and deposit rates sit at the moment, then a 'steady as she goes' statement is all that's needed.

Our attempt at a final 'bias' paragraph for the statement combines two separate elements from the September release:

“Continued high export commodity prices and, in time, reconstruction in Canterbury are expected to provide impetus to demand over the projection horizon. But for now, given the recent intensification in global economic and financial risks, it is prudent to continue to hold the OCR at 2.5 percent.”

This gets across three key points: it reinforces that the longer-term plan is still for higher interest rates as inflation pressures pick up; it highlights that international risks are the reason for delaying OCR hikes; and it avoids committing to a particular time frame for the next OCR move. After all, that timing is still highly contingent on how bank funding costs evolve – and we've seen in recent weeks how quickly these can turn in either direction.

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