

Sticking to the plan

April 28 OCR preview: RBNZ on hold at 2.50%

- **The March OCR cut was aimed at lessening the economic impact of the February earthquake, and combating the risk of a more chilling effect on nationwide confidence and activity.**
- **Recent data offers hope that the latter risk has been avoided. However, the RBNZ is not under any immediate pressure to reverse the cut, as it appears to have some breathing room on the inflation front.**
- **We expect this week's statement to reassert that monetary policy will be guided by the post-quake reconstruction timeline, which on current assumptions would put the first rate hike in Q1 next year.**

Despite the trying circumstances around the March *Monetary Policy Statement*, the RBNZ was able to articulate a clear plan for dealing with the economic impact of the 22 February earthquake. First up, the OCR was cut by 50bps as a precaution against a fall in confidence and activity, which could have extended well beyond those directly affected by the quake. Interest rates were projected to remain low until reconstruction got under way, after which rates would need to be raised quickly as the economy's spare capacity was soaked up.

We think this week's OCR statement will reiterate that timeline, despite some resilience in the post-quake data, and a return to the soaring commodity prices of 2007/08. The crucial difference between then and now is the degree of slack in the economy in the wake of a drawn-out recession. In this environment the RBNZ will be less concerned that high, policy-induced headline inflation could feed into inflation expectations and price-setting behaviour. The relatively strong exchange rate will further help to contain inflation, as well as keeping the RBNZ wary about near-term growth prospects.

The handful of post-quake data to date has provided some comfort that the risk of a post-quake downturn on a national scale has not been realised. Initial surveys of businesses and households showed the plunge in confidence that the RBNZ had braced itself for. However, subsequent readings have seen confidence stabilise or even pick up in some cases, with soaring

commodity prices leaving the agricultural sector particularly chirpy. Indeed, it seems that outside of the Canterbury region, economic activity has retained the momentum that was emerging in the early part of the year. Electronic card transactions have grown steadily in recent months, house sales have picked up (mostly in the squeezed Auckland market), and the PMI surveys indicate that the manufacturing and service sectors clung to growth in March.

However, the RBNZ will be aware that this growth is coming from an extremely weak starting point. The pace of recovery from the 2008/09 recession has been tepid so far, and stalled completely in the second half of 2010. The unemployment rate is still double its pre-recession low, and surveys show that capacity utilisation is below its ten-year average. There is still a lot of slack in the economy relative to its potential, which has and will continue to make it difficult for higher wage and price demands to take hold.

The New Zealand dollar's rise to a three-year high around US\$80c will further act to dampen inflation pressures. Notably, a recent speech by RBNZ Governor Bollard effectively endorsed the idea that a stronger exchange rate can – and should – play a role in containing the inflation pressures that arise from a commodity price boom.

As a result, we expect the RBNZ will stick with its intention to delay rate hikes until the reconstruction of Christchurch is under way. It's worth bearing in mind that the RBNZ can act fairly quickly on this – it will be (metaphorically) counting the cranes on the skyline, rather than waiting for the rebuild to show up in the official data. But based on the experience of the September quake, and the judgement of those close to the ground, the RBNZ expects that to happen in early 2012.

We agree that the RBNZ is more likely to leave the OCR unchanged for the rest of the year. But we acknowledge that this relies on two highly uncertain judgements: the initial degree of spare capacity in the economy, and the speed at which it gathers pace. Both of these will affect how quickly the economy reaches or exceeds its speed limit, and therefore how quickly the RBNZ will need to act.

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Judging the economy's spare capacity is tricky, since its 'potential' is itself unobservable. But one key piece of evidence is the subdued pace of underlying inflation, which continued into the March quarter. Apart from soaring world oil prices and some sizeable policy-imposed price increases, inflation pressures remained muted. Business surveys are telling us the same thing: firms are concerned about rising costs, but they have limited ability to pass these on. This is more consistent with a lot of slack in the economy than a little.

As for the pace of recovery, the strength of recent activity data is encouraging, but it suggests modest rather than raging growth, and from very depressed levels. And while it is possible that reconstruction activity could ramp up earlier than expected, there seems just as much chance that it could be delayed for longer.

Statement and market implications

We expect this week's RBNZ statement to be firmly on hold, while acknowledging that the post-quake data has held up better than might have been feared. We think the key phrase from March will be retained: "We expect that the current monetary policy accommodation will need to be removed once the rebuilding phase materialises. This will take some time."

The other key 'bias' statement – "Future monetary policy adjustments will be guided by emerging economic data" – is likely to be removed. At the time this was intended to leave the door open for further cuts if necessary; now, the emerging data is turning market opinion towards the possibility of early rate hikes, which is probably not the impression the RBNZ will want to leave.

Interest rate markets are currently pricing a 60% chance of an OCR hike by December – a figure that was pegged back a little after the softer-than-expected March quarter inflation figures. We expect those odds to be downgraded further after this week's review.

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