

# Not a moment too soon

## April 28 OCR review: OCR unchanged at 2.5%, RBNZ firmly on hold

- **The OCR was held at 2.50% as expected, with the RBNZ noting that national economic activity has held up well since the Christchurch earthquake.**
- **However, underlying inflation is seen as well contained for now. The RBNZ will continue to be guided by the timing of the post-quake reconstruction.**
- **We expect rate hikes to resume in early 2012, though with a steeper and more prolonged tightening track than the market is currently anticipating.**

The Reserve Bank left the cash rate unchanged at 2.50% this morning, as was universally expected. The media release gave little in the way of forward guidance, noting that rates were likely to remain low “for some time” – an implicit repeat of the March message that monetary policy will be dictated by the timeline of the post-quake reconstruction of Christchurch. That in itself is still highly uncertain, but based on best guesses we expect the first OCR hike to be early next year.

The assessment of recent economic developments was fairly upbeat. The RBNZ mentioned that nationwide activity had held up despite the earthquake, trading partner growth has remained robust, and export commodity prices have pushed higher. Consumer spending and on-farm investment are showing signs of picking up the pace.

But despite the improved economic picture, the RBNZ is very comfortable with the inflation outlook. Headline inflation is expected to settle comfortably within the 1-3% target band once a swathe of policy-induced price increases (GST, tobacco excise and the ETS) drop out of the annual rate.

The statement also noted that the high level of the New Zealand dollar was “unwelcome”, and would have some dampening effect on economic activity. It was only a few weeks ago that an RBNZ paper noted that a stronger exchange rate can – and should – play a role in capping the inflation pressures that arise from an export price boom. But a currency at three-year highs above USD80c may be getting beyond the RBNZ’s comfort zone.

Our view remains that the RBNZ will delay OCR hikes until next year. Yes, the economy is holding up surprisingly well. But the economy is currently operating far below its productive capacity, and there is ample room to grow before encountering inflationary speed limits. The strong exchange rate will continue to dampen inflation for some time. The main threat to inflation will be bottle-necks associated with Christchurch reconstruction, and that is unlikely to be an issue before 2012.

Once the hiking cycle is underway, however, we think it could be steeper and more prolonged than markets are anticipating. In March the RBNZ projected the cash rate to settle at around 4% by the end of next year. We’ve long been sceptical that such a historically low rate would be enough to neutralise inflation pressures, even with the extra complication that overseas funding has become more costly since the Global Financial Crisis.

Secondly, the post-quake reconstruction will be a feature of the economy for many years, and the resulting supply constraints won’t be resolved quickly. Monetary settings may need to be outright “tight” for some time if average inflation is to be contained within the target band. We expect the OCR to be lifted to 6% over the next three years.

### Market implications

In recent weeks the market had started to challenge the idea that the RBNZ could hold off on rate hikes for this year. Globally, concerns about inflation are growing, and New Zealand has certainly not been spared from the rise in oil and other commodity prices. Some have suggested that the RBNZ could be forced into raising rates before year-end. Today’s statement showed that the RBNZ doesn’t share those concerns – it is preparing to act swiftly once the reconstruction is under way, but not before.

The two-year swap rate fell three basis points after the announcement. Market pricing is still consistent with a 60% chance of a hike by year-end, which we think is on the high side. The NZ dollar initially fell half a cent to 0.8030, although it has since reclaimed much of this as the US dollar has continued to fall out of favour against everything.

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**RBNZ media release**

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

Reserve Bank Governor Alan Bollard said: “The outlook for the New Zealand economy remains very uncertain following February’s Christchurch earthquake.

“As was expected, business confidence, consumer spending and tourism activity all declined sharply following the earthquake. The OCR was cut as insurance to help limit these adverse effects. Confidence and consumer spending have since shown signs of recovery, but many firms and households remain adversely affected in Christchurch. To date, activity in the rest of the country appears relatively unaffected, with housing market turnover and business investment beginning to increase.

“Trading partner growth remains robust, helping push New Zealand’s export commodity prices higher. Along with relatively favourable climatic conditions, the improved price outlook is supporting a pickup in on-farm investment. Higher oil prices and the elevated level of the New Zealand dollar are both unwelcome. They will have some dampening effect on economic activity.

“Headline inflation is currently being boosted by recent increases in indirect taxes. Annual inflation is expected to settle comfortably within the target band once these tax increases drop out of the annual rate.

“Given the outlook for core inflation and continued economic disruption stemming from the earthquakes, the current level of the OCR is likely to remain appropriate for some time.”

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