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ECONOMIC ALERT

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

Why...

“Much of the current spike in inflation has been driven by the October 2010 increase in the rate of GST, and will therefore be temporary.”

Looking ahead...

“Provided current global financial risks recede and the economy continues to recover, the Bank sees little need for the March 2011 ‘insurance’ cut to remain in place much longer.”

But...

“The current very high value of the New Zealand dollar is acting as a drag on the New Zealand economy. If this persists, it is likely to reduce the need for further OCR increases in the short term.”

Market Implications

The Reserve Bank kept the OCR at 2.50% today, as universally expected. It was not what the Reserve Bank did that markets were keenly awaiting, rather it was what the Reserve Bank said.

The Reserve Bank delivered a short, balanced and highly conditional statement that reduced the likelihood of an OCR rise in the September *Monetary Policy Statement* but maintained the possibility of an OCR rise later this year and more in 2012. The markets welcomed the removal of one uncertainty.

The dust kicked up by today’s OCR Review will quickly settle, leaving markets to respond to domestic factors and react to offshore events. The fast-changing nature of those influences are likely to remain a feature.

Comment

The New Zealand dollar was little changed immediately after the Reserve Bank’s balanced statement. Its recent stronger bias and vulnerability to offshore influences remain intact.

Short swap rates rose a few basis points and longer swap rates fell a few basis points, causing the yield curve to flatten slightly.

In the short term, the Reserve Bank and the markets have to balance the near term constraints on the domestic economy from the high New Zealand dollar and “*current fragility in global financial markets, including the uncertainty around the US Government’s debt ceiling*” against the longer term effects of improving domestic economic growth and rising underlying inflation.

Unprecedented domestic and offshore events over recent months have increased economic and fiscal uncertainty and market volatility. Markets need to be wary about second-guessing economic, fiscal and monetary policy developments and need to reflect on solid evidence ahead of the next *Monetary Policy Statement* on 15 September.

The NZD and longer dated domestic interest rates are joined to the global financial markets’ roller coaster, as acknowledged by the Reserve Bank today. Uncertainty and volatility will remain features of domestic and global financial markets for a while yet.