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Westpac Institutional Bank

Its not that complicated

MPS preview, March 2013

- **We expect the RBNZ to repeat its simple "on hold" outlook for the OCR.**
- **There could be another warning that ongoing house price inflation would provoke early OCR hikes.**
- **The RBNZ may repeat the basic message that macroprudential tools are about financial stability, and are not OCR replacements.**

The Reserve Bank's last two communiqués on monetary policy have given a consistent message. The global and local economies are improving. The Canterbury rebuild is set to add an extra boost to New Zealand growth, although that will be partially offset by the dampening effects of government austerity and the high exchange rate. Overall, the RBNZ has said it expects inflation to rise from the current low level "slowly back towards the 2% target midpoint". This leads naturally to the conclusion that:

> "On balance, it remains appropriate for the OCR to be held at 2.5%"

In next week's *Monetary Policy Statement* (MPS), we expect the Reserve Bank to repeat verbatim that concluding sentence. The OCR outlook seems unlikely to change.

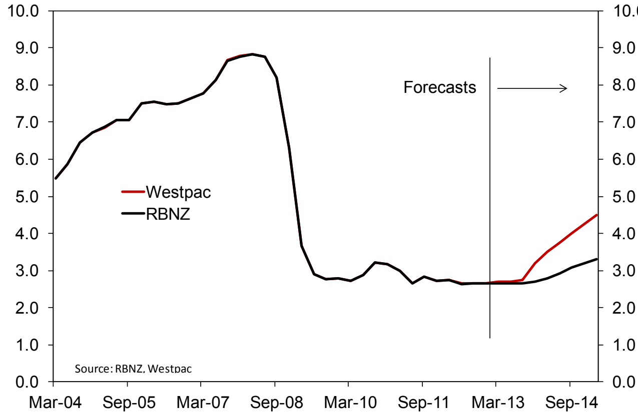
The general themes of the MPS are likely to be unchanged from previous missives, although one or two nuances may be highlighted. The RBNZ will probably mention that local economic activity has been stronger than anticipated in recent months. This will be countered by observations that inflation has been lower than expected and the trade-weighted exchange rate has risen 4% since December. The recently-declared drought will probably be described as an important downside risk, rather than being included in the RBNZ's central economic projections at this stage (the RBNZ's forecasts will have been finalised before drought was declared).

Within *Monetary Policy Statements* the RBNZ provides numerical forecasts of future interest rates. Back in December these forecasts implied that the RBNZ expected the OCR to remain unchanged until early-2014, and to rise slowly thereafter. The updated forecast could be the same this time.

The housing market: red rag to a hawk

In recent times the RBNZ has sounded louder warnings about rising house prices. A box on page 20 of the December MPS explained that rising house prices could "lead to higher inflationary pressures than is currently projected. All else equal, such a development could necessitate a higher OCR." In the January OCR review the housing market featured front-and-centre of the press release, with a comment that "The Bank does not want to see financial stability or inflation risks accentuated by housing demand getting too far ahead of supply."

90-day rate forecasts



Next week's *Monetary Policy Statement* will almost certainly contain similar warnings that if house prices continue to rise too rapidly, the OCR will need to rise earlier than previously forecast.

Our view is that the RBNZ's fears around housing will be realised. Given the current state of the market, house prices could easily rise 9% this year on a nationwide basis. That would be sufficient to provoke the RBNZ into earlier OCR hikes. Hence we expect the first hike to come in December 2013, and the follow-up pace of hikes over 2014 to be steeper than markets currently anticipate.

What about macroprudential tools?

The Reserve Bank of New Zealand is responsible for supervising the banking system as well as controlling inflation (the functions are separate in many other countries, including Australia). The RBNZ has recently announced a range of new tools to help it within that banking supervisory function - we described these so-called "macroprudential tools" in a bulletin on Monday this week.[1]

As we wrote on Monday, the RBNZ has been crystal-clear that these new tools are designed to prevent the build-up of risk in the financial system. They are about keeping banks safe. They are not replacements for the OCR. They are not designed to

1 http://www.westpac.co.nz/assets/Business/Economic-Updates/2013/Bulletins/Tool-Time.pdf

control inflation or house prices. That said, the deployment of macroprudential tools might have the *side-effect* of changing the inflation outlook –which would be important for monetary policy.

Next week's *Monetary Policy Statement* will probably contain another clarification of the relationship between macroprudential tools and monetary policy. Perhaps a box within the body of the MPS will give the following basic message: The RBNZ will deploy macroprudential tools only if it feels the banking system is at risk. The possible effects on the wider economy will then be taken into account when the RBNZ assesses the appropriate stance for the OCR. The two decisions will be separate.

Market implications

We suspect that the tone of the RBNZ's commentary on housing will been seen as hawkish by markets. This could dominate the inevitable negative commentary around the high New Zealand dollar and the emerging drought. Therefore the risks seem slightly skewed towards a market reaction in the direction of higher interest rates and a higher NZD on the day. That said, market reaction will be small if the RBNZ does repeat its overall "appropriate for the OCR to be held at 2.5%" bottom line.

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