Westpac Institutional Bank

Torn in two

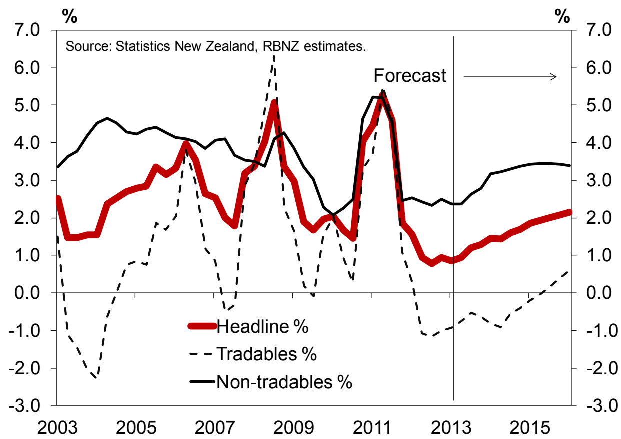
March *MPS* Review: OCR unchanged at 2.50%

- **The RBNZ reiterated the "on hold" outlook for the OCR in today's *Monetary Policy Statement*.**
- **The statement emphasised risks on both sides of this forecast – including the risk of OCR cuts if the exchange rate stays overvalued for longer.**
- **Markets were surprised by the mention of downside risks. Interest rates and the exchange rate fell after the release.**
- **We remain more worried about the upside risks – the idea that rising house prices will stoke consumer spending strikes us as a lot more than just a "risk".**

The Reserve Bank made a subtle but important change to the bottom line of today's monetary policy assessment, stating that there are both upside and downside risks to its projection for the Official Cash Rate to stay on hold at 2.50% over the next year.

On the upside, the economy is gaining momentum – helped by reconstruction in Canterbury – and the housing market is heating up, which together could add to domestic inflation pressures. But on the downside, the exchange rate has been persistently strong, undermining export returns and creating a serious downward drag on prices of tradable goods. It was the mention of downside risks – including the possibility that the OCR could be reduced – that caught markets' attention. The two-year swap rate fell 10 basis points in response, and the exchange rate fell nearly a cent.

Figure 1: RBNZ inflation forecasts, tradables and non-tradables



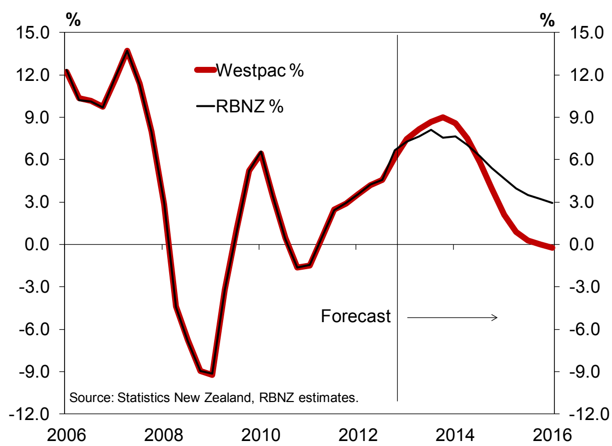
Diverging trends for the tradable and non-tradable sectors is hardly a new dilemma for the RBNZ, nor is this the first time in recent history that the RBNZ has opened the door to interest rate cuts. The risk of a stronger-for-longer exchange rate is very real. But what the RBNZ describes as "upside risks" strike us as highly likely. We fully expect rising house prices and booming construction activity to provoke more consumer spending and lead to inflationary pressures. Hence we expect earlier and steeper OCR hikes.

Our own forecast is for OCR hikes to begin in December this year, with the caveat that if drought persists we will shift that to a later start date.

Details

The major updates to the RBNZ's forecasts were a reflection of a stronger than expected rebound in near-term activity, balanced against a higher exchange rate. The RBNZ estimates that after a soft patch in mid-2012, GDP growth accelerated to 0.8% in the December quarter. (We'll finalise our forecast tomorrow, but we see upside risk to that.) Beyond this, growth is expected to pick up to around 3.5% yr by 2014. Post-quake reconstruction will play an important part, partially offset by ongoing fiscal tightening.

Figure 2: House price inflation forecasts, Westpac and RBNZ

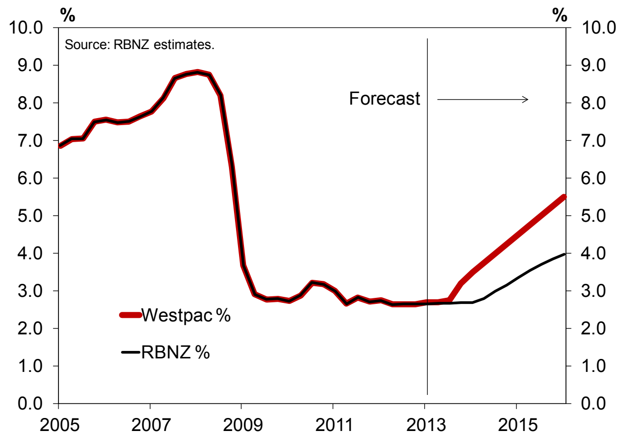


The RBNZ has also revised up its house price forecasts in response to the market's continued strength, and indeed its forecasts are now fairly similar to our own. The point of difference has been – and remains – what this implies for household spending. The RBNZ has taken the view that consumers will respond more cautiously than in the past to an increase in household wealth; we're not so sure.

Drought conditions were noted as a downside risk to growth over the next year, although it's difficult to pin this down as the situation has been evolving quickly. So far the RBNZ has allowed for a hit to growth of around 0.2-0.3% of GDP, but this is likely to be explored more fully in future statements.

The RBNZ's 90-day interest rate projections were similar to those in December, with a slight delay to the tightening cycle (implying a September 2014 start rather than June 2014). However, beyond that point interest rates are projected to rise a little quicker and further than they were in December. With credit spreads narrowing and independent cuts to mortgage rates in recent times, the RBNZ may have shaded up its assessment of the long-run 'neutral' level of the OCR.

Figure 3: 90-day rate forecasts, Westpac and RBNZ



The RBNZ's economic forecasts were broadly in line with what we expected. What surprised us, and the market, was how the RBNZ portrayed the balance of risks around its central view. The first notable change was in the bottom line of the media release, which for many months has been some variation of: "On balance, it remains appropriate for the OCR to be held at 2.5 percent." Today's statement noted instead that:

> *"There are both upside and downside risks to this [inflation] outlook. At this point we expect to keep the OCR unchanged through the end of the year."*

The case for downside risks was spelled out more explicitly in a box in the *Monetary Policy Statement.* If the exchange rate remained persistently high, and out of line with fundamentals, the RBNZ may need to cut interest rates in the near future. The consequences of this would include faster growth, higher non-tradables inflation (but lower tradables inflation), and a larger current account deficit as economic imbalances worsen.

We note that this is not the first time in recent history that the RBNZ has opened the door to interest rate cuts. Last April it said: "Should the exchange rate remain strong without anything else changing, the Bank would need to reassess the outlook for monetary policy settings." (A subsequent 5% fall in the trade-weighted index meant that the issue was off the table by the June MPS). We emphasised at the time that this was no idle threat, and we won't downplay the possibility today.

The upside risks to the inflation outlook, on the other hand, are well-trodden. The RBNZ is currently assuming that rising house prices will not lead to the usual increase in consumer spending. And it is further assuming that the construction boom will not generate the usual degree of inflation pressure. The RBNZ is of course cognisant of the risk that these assumptions could prove incorrect – if they do, inflation pressures could exceed the RBNZ's forecast.

For our part, we find both assumptions highly suspect. Our view is that the present cycle will closely follow historical trends – rising house prices will generate a "borrow and spend" dynamic and booming construction will provoke inflation pressures. Hence we foresee a greater series of OCR hikes than the RBNZ is forecasting.

That said, drought is a definite risk to our OCR forecast. We are currently forecasting a December OCR hike. But if drought conditions linger much longer, we would revise that call with an eye to later interest rate increases.

Media release

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

Reserve Bank Governor Graeme Wheeler said: "The downside risks around global growth have receded in recent months, and financial market sentiment has improved.

"Domestically, the economic recovery is uneven. While demand and output are expanding, the labour market remains weak. Economic growth and inflation are being shaped by a range of forces. The Canterbury rebuild is gaining momentum and residential investment and business and consumer confidence are increasing. House price inflation is increasing and the Bank does not want to see financial stability or inflation risks accentuated by housing demand getting too far ahead of supply.

"The overvalued New Zealand dollar is undermining profitability in export and import competing industries, and worsening drought conditions are creating difficulty in much of the country. Ongoing fiscal consolidation will also act to slow overall demand.

"We project the economy to grow at an annual rate of between 2 and 3 percent over the forecast period. Inflation is expected to rise gradually towards the 2 percent midpoint of the target range.

"There are both upside and downside risks to this outlook. At this point we expect to keep the OCR unchanged through the end of the year."

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