Westpac Institutional Bank

Uncomfortably perched on the fence

OCR preview, April 2013

- **We expect the RBNZ to maintain its "firmly on hold" stance for the OCR**
- **But the risks on both sides of the outlook will receive more emphasis**

The Reserve Bank of New Zealand has sat with the OCR at 2.5% for two years. But recently this has started looking less like "sitting pretty" and more like "sitting on the fence." And that's becoming an uncomfortable place to be.

The central bank faces a tough dichotomy. On one side, the Christchurch rebuild and rising house prices have produced surprisingly rapid economic growth and could lead to inflation pressures. But on the other, inflation is low due to the high exchange rate - and the exchange rate could rise even further.

The Reserve Bank is unable at this stage to determine which side of the dichotomy is the most germane. So it has sensibly opted to sit on the fence. In the March *Monetary Policy Statement* the RBNZ noted that if the exchange rate were to stay high and continue to suppress inflation, OCR cuts might be on the agenda. But last week Deputy Governor Grant Spencer said in a speech that if the housing market were to stay strong and provoke consumer spending, the OCR may have to go up early. There is no contradiction between these two statements. They simply reflect the fact that the central bank faces two diametrically opposed risks.

At next week's OCR review, we expect the RBNZ will remain perched on the fence, but will express its increasing discomfort with the risks on either side.

The final paragraph of the release could well be a verbatim repeat from the March MPS:

"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."

That said, the Reserve Bank's summary of the outlook will have to be updated to reflect the fact that if anything, the economic dichotomy has become starker.

The RBNZ may back up a little on its March comment that global "risks have receded", following the bailout crisis in Cyprus.

Wording around the local economy will have to become more bullish. GDP growth in the December quarter was much stronger than the RBNZ expected, and recent survey data suggest that the buoyancy has rolled on into the new year.

The link between rising house prices and consumer spending may be singled out for special mention. Private consumption expenditure grew 1.4% in the December quarter, possibly signalling a return to our borrow-and-spend ways of last decade.

The RBNZ will mention both the drought, which will hit agricultural production hard, and the recent 66% increase in dairy export prices that will soften the blow.

As always, the RBNZ will rail against the high exchange rate. Given that the Trade Weighted Index has risen to a new all-time high, the RBNZ might even invoke language associated with exchange rate intervention, such as labelling the New Zealand dollar "unjustified" and "exceptional" (these are two of the RBNZ's four criteria for intervention).

Finally, the RBNZ will no doubt point out that inflation is currently low but is expected to "rise gradually" towards 2 percent.

Market implications

If the OCR review turns out along the lines we are suggesting, nobody will be surprised and markets will not react. Even so, the nature of the dichotomous risks facing the RBNZ means there is scope for markets to move if the RBNZ unexpectedly emphasises the risks on one side more than the other.

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