Westpac Institutional Bank

Hold the horses
OCR preview, July 2013

- **We expect the RBNZ to retain its "firmly on hold" stance.**
- **The RBNZ is unlikely to announce LVR restrictions on Thursday.**
- **Markets are looking for signs of early hikes, but may be disappointed.**
- **We believe the RBNZ will eventually shift to a more hawkish stance, but now is not the time.**

Markets are champing at the bit to price in OCR hikes. The RBNZ may want to move in the same direction, but not as eagerly as markets. So Thursday's OCR review may be an exercise in reigning in expectations.

For a long while the Reserve Bank has been stuck between a rock and a hard place. The improving economy portends future inflationary pressures, but in the near term the very high exchange rate has suppressed inflation. The RBNZ has navigated a middle course, signalling that it expects to keep the OCR unchanged this year before the barest of OCR hiking cycles is initiated in 2014.

Market pricing roughly agreed with the RBNZ's message until a few weeks ago. But a radical change in sentiment has seen markets move to price in three OCR hikes by the end of next year.

There were two catalysts for the market's lurch in a hawkish direction. The New Zealand dollar dropped against the US dollar, and a swathe of data showed the New Zealand economy is firmly in the grip of an economic upturn.

To be sure, these are important developments and they will influence the Reserve Bank's thinking to some extent. But central bankers are a cautious bunch, and are unlikely to leap to any conclusion as rapidly as markets have. What's more, there are a few considerations that will take the gloss off the case for early OCR hikes in the RBNZ's mind.

First, the fall in the exchange rate is not so significant when viewed through a trade-weighted lens. The kiwi has actually strengthened against the Australian dollar, such that the trade weighted index is only 4% lower than the RBNZ projected in the June *Monetary Policy Statement.* On Thursday the RBNZ will presumably acknowledge the fall in the TWI, but will probably also complain that the exchange rate remains overvalued.

Second, fixed mortgage rates have risen between 15 and 25 basis points in recent weeks. This will weigh on the housing market, thereby reducing the need for the Reserve Bank to raise the OCR.

And finally, it is worth bearing in mind that most economists, Reserve Bank included, have long been anticipating a period of elevated economic growth associated with the Canterbury rebuild. The fact that this growth has now arrived is not cause for the Reserve Bank to alter its expectations for future monetary policy.

So we expect Thursday's OCR review will hew closely to the wording of previous statements. The RBNZ will probably repeat that it expects *"GDP growth to accelerate to about 3.5 percent by the second half of 2014, and inflation to rise towards the midpoint of the 1 to 3 percent target band."* We firmly expect the RBNZ will repeat its bottom-line OCR guidance of *"we expect to keep the OCR unchanged through the end of the year".*

While the Reserve Bank is holding the line on interest rates, there are changes afoot in its financial stability role. The RBNZ is concerned that rising house prices pose a financial stability risk, and has clearly signalled its intention to place limits on high loan-to-value ratio (LVR) lending in the near future. However, Thursday is not the time to announce LVR restrictions or even to provide details – OCR reviews are about the OCR. That said, the RBNZ will probably repeat the observation it has made at each OCR review this year: *"The Bank does not want to see financial stability or inflation risks accentuated by housing demand getting too far ahead of supply".*

Market implications

We expect the RBNZ will give no encouragement to the idea that the OCR could be hiked this year or early next year. If that is correct, interest rates and the NZD will fall slightly after the OCR review. However, markets will almost certainly persist in pricing more OCR hikes than the RBNZ is officially forecasting, and with good reason. Westpac's view is that the RBNZ will eventually have to shift to a more hawkish stance, as the Canterbury rebuild proves inflationary. But Thursday is not the time to announce such a change in stance.

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