24 April 2013

Westpac Institutional Bank

Still on the fence

OCR Review, April 2013

- **As expected, the RBNZ repeated its "on hold" OCR stance.**
- **The RBNZ is caught between two opposing forces...**
- **...but is under no pressure to decide which is more pressing.**
- **This "wait and see" approach is sensible.**
- **We now expect the RBNZ will leave the OCR unchanged until March 2014.**

The Reserve Bank today issued a very neutral OCR review. The bottom line was a verbatim repeat from March:

"At this point we expect to keep the OCR unchanged through the end of the year."

This was very much as we expected. The RBNZ is currently caught between two opposing forces. Local growth has picked up considerably, driven by the post-earthquake Canterbury rebuild and rising house prices. However, inflation is below the RBNZ's target and could go lower from here, due to the inflation-suppressing effects of the high New Zealand dollar.

The RBNZ can't hike the OCR early for fear of exacerbating the high exchange rate and pushing inflation even further below target in the short run; equally, it can't reduce the OCR or keep it unchanged forever, for fear of stoking the overvalued housing market and creating runaway inflation in the longer term. So the RBNZ has sensibly opted to continue sitting on the fence, to reuse our metaphor from last week.

The body of the OCR review was a factual description of the opposing forces facing the New Zealand economy:

- Global financial markets were described as "buoyant" and NZ's trading partners' GDP outlook "firm".
- The pick-up in domestic economic growth and consumer spending was mentioned, and the RBNZ repeated its concern that house prices are rising too quickly.
- However, domestic negatives were fiscal consolidation and drought.
- The RBNZ repeated its assessment that the exchange rate is overvalued. However, the degree of concern that it expressed about the high exchange rate was no different to previous statements. The latest appreciation in the TWI was blamed on Japanese quantitative easing.
- The RBNZ acknowledged that inflation is currently low, and is expected to remain "close to the bottom of the target range this year." However, the RBNZ is not too fazed by near-term inflation. Instead it emphasised its forecast that inflation will "gradually rise towards the 2 percent target midpoint."

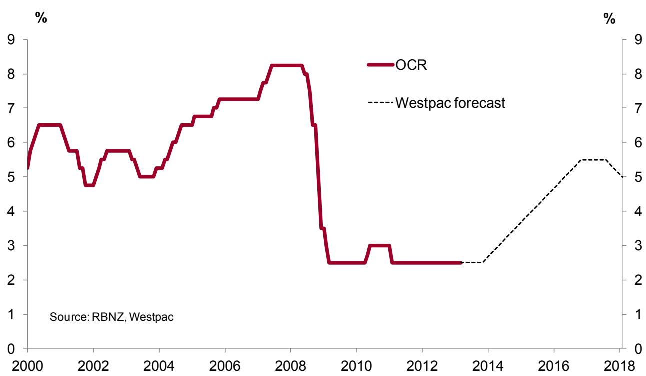
At some point one or the other of the opposing forces will win out, forcing the RBNZ to climb down from its current position on the fence. Our money is on rebuild- and housing-induced domestic inflation eventually proving the more pertinent long-run influence. Over the course of New Zealand's history, construction booms have generated inflation pressures and rising house prices have provoked consumer spending. We believe those same patterns will be repeated in the upcoming cycle – and we don't believe the RBNZ has taken sufficient account of that.

But the evolution from construction boom and rising house prices to widespread inflation pressures will be slow. For now, inflation is below the RBNZ's target. And the latest rise in the exchange rate, combined with falling petrol prices, could cause inflation to drop even further in the short run. We agree with the RBNZ's assessment that inflation will remain close to 1% for the whole of this year. And therefore we agree that the best course of action this year is to keep the OCR on hold while waiting and seeing what happens to domestic inflation.

Westpac's OCR forecast

The RBNZ has time on its side. Consequently, we now expect the OCR will remain on hold at 2.5% until March 2014 (previously we were forecasting a hike in December 2013). This change in call is a consequence of ongoing low near-term inflation, and brings us broadly into line with financial market pricing. The OCR hiking cycle that we envisage is modest by historical standards, but is far greater in extent than financial markets are currently prepared for.

Official Cash Rate



Financial market reaction to the RBNZ statement

Financial markets evidently feared that the Reserve Bank would react strongly to the rise in the New Zealand dollar – perhaps even by signalling intervention. When no such commentary was forthcoming, the NZD rose nearly half a cent and the two-year swap rate rose by 3 basis points.

RBNZ media release

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

Reserve Bank Governor Graeme Wheeler said: "The outlook for monetary policy remains consistent with that described in the March Monetary Policy Statement.

"Despite continued strains in Europe and disappointing data in some countries most recently, global financial market sentiment remains buoyant and the medium-term outlook for New Zealand's overall trading partner GDP growth remains firm.

"Growth in the New Zealand economy has picked up. Consumer spending has increased and rebuild activity in Canterbury is gaining momentum. House price inflation is high in some regions, despite prices already being elevated. The Bank does not want to see financial or price stability compromised by housing demand getting too far ahead of supply.

"Fiscal consolidation is constraining aggregate demand. In addition, drought has lowered agricultural production and will likely also negatively affect farm output in the coming season. International dairy prices have spiked higher in response to the drought, but these price gains could prove temporary.

"The New Zealand dollar remains overvalued and is higher than projected in March. Further appreciation has occurred partly in response to the announcement of a substantial quantitative easing programme in Japan. The high New Zealand dollar continues to be a significant headwind for the tradables sector, restricting export earnings and encouraging demand for imports.

"The CPI increased 0.9 percent in the year to the March quarter and is expected to remain close to the bottom of the target range this year. Weak near-term inflation prospects need to be balanced against our projection for inflation to gradually rise towards the 2 percent target midpoint.

"At this point, we expect to keep the OCR unchanged through the end of the year."

Dominick Stephens
Chief Economist

Westpac Economics Team Contact Details

Dominick Stephens, Chief Economist	Ph: (64-9) 336 5671	dominick_stephens@westpac.co.nz
Michael Gordon, Senior Economist	Ph: (64-9) 336 5670	michael_gordon@westpac.co.nz
Felix Delbrück, Senior Economist	Ph: (64-9) 336 5668	felix_delbruck@westpac.co.nz
Nathan Penny, Economist	Ph: (64-9) 336 5669	nathan_penny@westpac.co.nz