Westpac Institutional Bank

The house view

January 31 OCR review: RBNZ on hold at 2.50%

- **The RBNZ reiterated its "on hold" stance for the OCR.**
- **The inflation outlook was softened slightly, despite bullish growth expectations.**
- **But the RBNZ expressed real concern about potential inflation or financial stability issues arising from rising house prices and expanding credit growth.**
- **We continue to forecast an OCR hiking cycle that begins in December 2013 and eventually extends far further than markets are currently pricing.**

The RBNZ left the Official Cash Rate at 2.5% and maintained the "on hold" outlook for the OCR. The review downplayed the high exchange rate and the current low level of inflation in a low-key way, while focussing on the positive economic outlook and rising house prices. We agree strongly with that set of priorities, but the review was more hawkish on inflation than we or markets thought the RBNZ would dare to be at this stage. Consequently, two-year swap rates rose 3bp and the NZD rose nearly half a cent.

As expected, the RBNZ made no change to the bottom line OCR outlook, repeating the key phrase from last December: *"On balance it remains appropriate for the OCR to be held at 2.5 percent".*

Also as expected, the RBNZ acknowledged the overvalued exchange rate, the weak labour market, and the fact that inflation is currently below target. But all this culminated in only the slightest softening of the inflation outlook. Last December the RBNZ said it expected spare capacity would be *"eliminated"* by the end of this year and inflation would rise towards 2% *"gradually"*. Those key words were softened to spare capacity being *"reduced"* this year and inflation rising *"slowly"* towards 2%.

In contrast, commentary on the global and domestic economic outlooks was very bullish. On the global economy the RBNZ said "growth is set to recover", and domestically *"recent data ... suggest GDP growth is recovering."*

Importantly, the RBNZ pointed out that positive global financial market sentiment is *"contributing to lower bank funding costs and some reduction in interest rates faced by households and firms."* The so-called "mortgage war" (an autonomous decline in fixed mortgage rates) means the OCR must be set at a higher level in order to maintain the same overall level of interest rates.

But the really hawkish part of this OCR review was the interpretation of the housing market and credit growth: *"House price inflation has increased and we are watching this and household credit growth closely. The Bank does not want to see financial stability or inflation risks accentuated by housing demand getting too far ahead of supply."* The RBNZ is acknowledging that rising house prices could provoke inflation pressure and unbalance the economy (something we agree with strongly). Perhaps the RBNZ is finally warming to the idea that house prices will continue rising in response to low interest rates, and is moving away from the sanguine view that house price inflation will moderate once housing supply increases.

The references to credit growth and financial stability were a direct invocation of the RBNZ's new Policy Targets Agreement, which requires it to have regard to financial stability. The RBNZ has effectively issued a reminder that it has the right to keep interest rates higher than inflation targeting alone would warrant, in order to prevent excessive lending from imperilling financial stability. For the record, New Zealand is currently not in a situation of "excessive credit growth". But recent credit data has shown a marked acceleration in lending to households, and further data at 3:00pm today may show likewise.

We agree with the RBNZ's assessment of the economic situation, and we welcome the change in view around housing. Our key view over the past year has been that so long as interest rates remain low, house prices would rise aggressively. We have long expressed concern about the potential for rising house prices to unbalance the economy. And we have long been concerned that the Canterbury rebuild would provoke inflation pressure, necessitating higher interest rates. The way to check the emergence of these imbalances and inflationary pressures will be to lift interest rates from their current record lows. We continue to forecast an OCR hiking cycle that begins in December 2013 and extends far further than markets are currently pricing.

RBNZ media release

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

Reserve Bank Governor Graeme Wheeler said: “Global growth is set to recover in 2013 with economic indicators improving in many of our trading partners. Consistent with this, global financial market sentiment is positive, contributing to lower bank funding costs and some reduction in interest rates faced by households and firms in New Zealand.

“Domestically, recent data on business confidence and construction activity suggest GDP growth is recovering from the softness seen through the middle of last year. The Canterbury rebuild is gathering momentum and its impact will be felt more broadly in incomes and domestic demand. House price inflation has increased and we are watching this and household credit growth closely. The Bank does not want to see financial stability or inflation risks accentuated by housing demand getting too far ahead of supply.

“Inflation remains subdued and is currently just below the bottom of the Reserve Bank’s inflation target range. This mainly reflects the impact of the overvalued New Zealand dollar. The high currency is directly supressing inflation on traded goods, and is undermining profitability in export and import competing industries. At the same time, the labour market remains weak and fiscal consolidation is dampening growth.
Overall, we expect economic growth to strengthen over the coming year, reducing spare capacity and bringing inflation slowly back towards the 2 percent target midpoint.

“On balance, it remains appropriate for the OCR to be held at 2.5 percent.”

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