Westpac

Institutional Bank

Now that's more like it

OCR review, July 2013

- **The Reserve Bank has shifted to an explicit hiking bias, its first significant change of stance since December 2011.**
- **The RBNZ is becoming more concerned about the inflation consequences of rising house prices and the construction boom.**
- **This fits with our views. We expect the OCR hiking cycle will begin in March 2014 and peak at 5.5%.**

The RBNZ today announced a significant change in the stance of monetary policy. From December 2011 until June 2013 the RBNZ had maintained an "on hold" bias in the text of its OCR reviews and Monetary Policy Statements. Today the final sentence of the OCR review introduced an explicit tightening bias, although hiking the OCR this year was ruled out:

"Although the removal of monetary stimulus will likely be needed in the future, we expect the keep the OCR unchanged through the end of this year."

It seems the RBNZ now expects to hike the OCR in early, rather than late, 2014.

Compared to previous OCR reviews, the RBNZ has become slightly more bullish on the New Zealand economy, noting that the upturn had become *"more widespread"*. The RBNZ's concern about the high New Zealand dollar was also downgraded following the drop below 80c against the US dollar, though only slightly. The exchange rate is now described as *"high"* rather than *"overvalued"*.

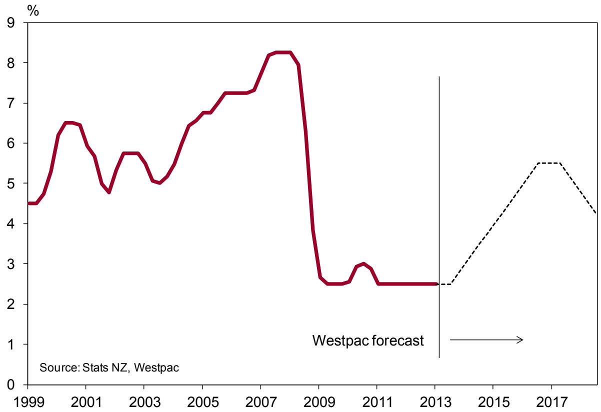
But the real motivation for the RBNZ's change in stance came in the paragraphs concerning inflation. The RBNZ has long signalled that it expects inflation to gradually rise towards 2%. But for the first time in a long while, the expected increase in inflation was linked to rising house prices and the construction boom.

There is an important back-story here. Some time ago the Reserve Bank adopted explicit assumptions that rising house prices would not provoke much extra consumer spending, and that the Canterbury rebuild would prove less inflationary than historical construction booms. Based on those assumptions, the RBNZ felt that the OCR could be maintained at a very low level for years without jeopardising its 2% inflation target. It forecast the OCR to remain below 4% until 2016.

The subtext was always clear. Should the assumptions be disproven, the outlook for the OCR would have to be revised.

Westpac disagreed with these sanguine assumptions on consumer spending and construction-related inflation from the outset.

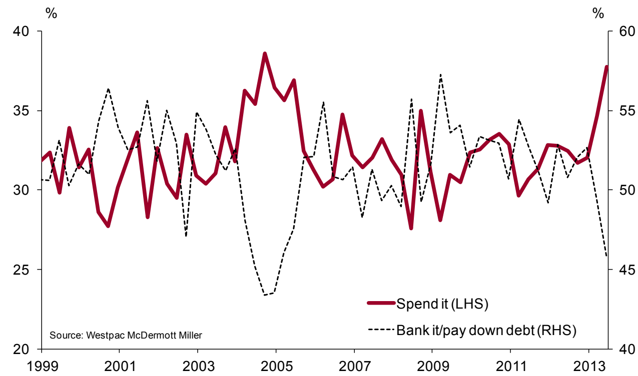
Westpac's OCR forecast



We saw no compelling reasons that this cycle would be different to past housing and construction booms. Consequently, our own forecasts incorporated the idea that households would spend up on the back of rising house prices, and that the construction boom would provoke inflation pressures.

The jury was out on these questions until just a few months ago. This is no longer the case. Very clear evidence in favour of consumer spending has emerged. For example, the proportion of households in the Westpac McDermott Millar Consumer Confidence Index saying they would spend rather than save a $10,000 windfall jumped sharply over the first half of this year. Household borrowing is now growing comfortably faster than national income. So is retail spending.

How would you spend a $10,000 windfall?



As for construction-related inflation, until recently this was strictly contained to the Canterbury region and inflation was low on all fronts. But evidence of widespread construction-related inflation clearly emerged in the June quarter Consumer Price Index figures, released last week.

Indeed, we actually thought the RBNZ would mull this evidence a little longer before changing stance, so we were slightly surprised by the hawkishness of today's OCR review.

As for how the RBNZ intends to react to these putative inflationary pressures, the penultimate sentence of the OCR review was crystal clear:

"The extent of the monetary policy response will depend largely on the degree to which the growing momentum in the housing market and construction sector spills over into inflation pressures."

All this supports our view that the first OCR hike will come in March 2014, and the OCR will rise to 5.5% by the end of 2016.

The next chapter

Even as some issues are becoming clearer, new uncertainties around monetary policy are emerging.

The first is the trajectory of the exchange rate. The New Zealand dollar has fallen against the US dollar because the US Federal Reserve has issued a signal that it intends to "taper" the pace of quantitative easing (slow the rate of money-printing). If the Fed does taper, the New Zealand dollar could fall further. This would push up prices for imported goods and services, requiring early OCR hikes. But the Fed's tapering signal was conditional on US data remaining strong, and on that front we are doubtful. If our doubts are vindicated the New Zealand dollar will strengthen again, thus reducing the need for OCR hikes.

The second uncertainty is the RBNZ's intention to invoke speed limits on banks' ability to lend at high loan-to-value ratios (LVRs). Nobody can be certain of how LVR restrictions will affect the housing market. Our tentative view is that house prices will continue marching higher as investor demand supports prices. So on that front we remain of the view that OCR hikes are necessary.

Market reaction

Markets were positioned for an unchanged review, so the reaction has been to send interest rates and the exchange rate higher. So far the 2-year swap rate has risen 8bp to 3.30%, and the exchange rate has risen half a cent against the US dollar. We suspect that market reaction will continue in the same direction throughout the day.

Markets are now pricing in a full OCR hike for March 2014, and further hikes over the course of 2014. We agree with that.

Full RBNZ statement

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

Reserve Bank Governor Graeme Wheeler said: "The global outlook remains mixed, with the euro area still in recession and signs of slower growth in China and Australia, but more positive recent indicators in the United States and Japan. Global debt markets have become more cautious due to uncertainty around the Federal Reserve's anticipated exit from quantitative easing.

"Growth in the New Zealand economy is picking up and, although uneven, is becoming more widespread across sectors. Consumption is increasing and reconstruction in Canterbury will be reinforced by a broader national recovery in construction activity, particularly in Auckland. This will support aggregate activity and eventually help to ease the housing shortage.

"In the meantime rapid house price inflation persists in Auckland and Canterbury. As previously noted, the Reserve Bank does not want to see financial or price stability compromised by housing demand getting too far ahead of the supply response.

"Despite having fallen on a trade-weighted basis since May 2013, the New Zealand dollar remains high and continues to be a headwind for the tradables sector, restricting export earnings and encouraging demand for imports. Fiscal consolidation will weigh on aggregate demand over the projection horizon.

"CPI inflation has been very low over the past year, reflecting the high New Zealand dollar and strong international and domestic competition. However, inflation is expected to trend upwards towards the mid-point of the 1-3 percent target band as growth accelerates over the coming year.

"The extent of the monetary policy response will depend largely on the degree to which the growing momentum in the housing market and construction sector spills over into inflation pressures.

"Although removal of monetary stimulus will likely be needed in the future, 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