7 June 2013

Westpac Institutional Bank

Houdini escapes the bind?

Monetary Policy Statement preview, June 2013

- **Monetary policy has been in a bind for some time, trapped between rising house prices and the high exchange rate.**
- **The RBNZ now appears more open to restricting mortgage lending, and hopes this might offer a Houdini-style escape from the bind.**
- **We expect the front page of the *MPS* will be slightly more hawkish than previous missives, and the 90-day rate forecast will be higher.**
- **But the body of the *MPS* will note that if mortgage restrictions are invoked, OCR hikes may be less necessary.**

For some time now monetary policy has been in a bind. Economic growth has picked up substantially on the back of Canterbury's post-earthquake rebuild, and house prices are now rising quite rapidly. In such circumstances the Reserve Bank would normally lift interest rates, lest inflation rear its ugly head in years to come.

But for now inflation is below the bottom of the Reserve Bank's 1% to 3% target band, owing to low global inflation and the strong New Zealand dollar. Hiking interest rates now could push the exchange rate even higher, which would risk inflation dropping even further below target.

So the Reserve Bank is stuck, and has been forced to keep the OCR on hold. Its interest rate forecasts have implied that the OCR will remain at 2.5% until at least mid-2014 before rising slowly, and its recent *Monetary Policy Statements* have even-handedly discussed risks on both sides of that outlook

In recent months economic buoyancy has become more intense, while the low inflation / high exchange rate dynamic has not changed.

The economy decisively outstripped the RBNZ's expectation over the six months to March 2013 – we estimate growth over the half year was 2.3% against the RBNZ's forecast of 1.4%. True, the summer drought will jostle activity levels through the middle of the year, but this must be balanced against the temporary income boost New Zealand is receiving via record prices for dairy products on global markets. The Government has signalled a slight loosening of its tightly bound purse-strings. And importantly, the labour market is now clearly improving – we can now rest assured that last year's spike to 7.3% unemployment was a chimera.

Meanwhile, inflation and the exchange rate have changed little. Inflation is only a whisker below forecast. The exchange rate is high, but no more so than the RBNZ allowed for back in March. The drop in inflation expectations to 2.1% was a significant victory for the central bank that invented inflation targeting – but again, this was expected.

So we expect the June *Monetary Policy Statement* will carry a slightly more "hawkish" tone than previous missives. The Monetary Policy Statement will explain both sides of the high-growth-versus-low-inflation dilemma, but slightly more attention will be given to the improving economy than in earlier statements. The RBNZ's interest rate forecast (normally charted in Chapter 2 of the *MPS*) may be upgraded slightly, in the order of 20 basis points.

However, we do not expect the RBNZ to go so far as altering the "bottom line" OCR outlook sentence that completes its monetary policy press releases – we anticipate a repeat from both the April and March statements:

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

What about macroprudential tools?

So far, so simple. But the plot thickens.

The most difficult aspect of the RBNZ's dilemma is that the longer interest rates stay low, the greater the probability of a boom/bust cycle in the housing market. This threatens the RBNZ's financial stability goals, so it has been making noises about using macroprudential tools to ensure the stability of the financial system. Using such tools for financial stability reasons would affect the monetary policy outlook – and therefore they need to be taken into account in next week's *Monetary Policy Statement.*

Previously, the macroprudential tool the Reserve Bank seemed most likely to use was the Countercyclical Capital Buffer. This would have been effective at shoring up the banking system, but would have had very little impact on mortgage rates, the housing market, or the economy, and could therefore be ignored by monetary policy watchers like ourselves.

But in a speech last week, Mr Wheeler talked up the possibility of restricting the proportion of new loans banks are allowed to make above a certain loan-to-value ratio (LVR). Mr Wheeler went on to make the case that these LVR speed limits might be a way of escaping, Houdini-style, from the monetary policy bind. The proposition was that LVR speed limits might curtail house price rises, thus cooling the economy. Mr Wheeler even went so far as to propose that if house prices became "much less of a concern", the OCR could be reduced.

The language in Mr Wheeler's speech was tentative, full of 'ifs' and 'mights'. That is entirely appropriate. The RBNZ has not yet made any commitment to restrict mortgage lending. And the fact is, nobody really knows what LVR speed limits will do to the housing market or the economy, because they have not been tried in recent decades in New Zealand.

Next week's *MPS* must strike a delicate balance on this topic. It must consider the *possibility* that LVR speed limits will be invoked in the future, without appearing to *commit* to their use. The best approach would be to base the formal monetary policy forecasts on the assumption that LVR speed limits are not invoked, but to discuss their possible use in a standalone box. The upshot of the box would be that if LVR speed limits are used, 90-day rates may not rise as rapidly as the central forecasts suggest.

Market implications

The RBNZ faces the unenviable challenge of delivering a rather complicated message to markets this time – developments have leaned in a hawkish direction but this might be offset by macroprudential tools. There is every possibility that markets will overreact to one aspect or the other of the *MPS,* creating either whippy price action or even a wholesale misfire that the RBNZ would later have to correct in a speech. But if the RBNZ is careful in its delivery and market analysts are careful in their interpretation, we expect that the net effect of this *MPS* will be zero change in the yield curve.

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