

# Necessary measures

## December 2013 MPS Review: OCR unchanged at 2.50%, hikes expected next year

- The Reserve Bank maintained its message that the OCR will need to go up next year.
- The economy is in a self-sustaining upturn, aided by high export prices, quake reconstruction and housing market momentum. In this environment, there is less need for stimulus from low interest rates.
- The RBNZ is conscious that domestic inflation, once allowed to take hold, can be very tough to eliminate.
- With that in mind, it is willing to look past low near-term inflation and a high exchange rate to some degree, in order to keep the medium-term inflation outlook on target.
- The RBNZ's projections are most consistent with an OCR hike in March next year. We accept this as the best forecast of the timing of the first move, though we note that the risks are skewed towards later rather than earlier.

Today's *Monetary Policy Statement (MPS)* saw the Reserve Bank continue to press the case for higher interest rates next year. Rising domestic demand will eventually translate into home-grown inflation pressures, and the RBNZ knows from experience that once this form of inflation takes hold, it can be difficult to squeeze out of the system again. Accordingly, the RBNZ seems prepared to tolerate a high exchange rate and weak tradables inflation to some degree, as long as the medium-term outlook remains for inflation to reach the 2% midpoint of the target band.

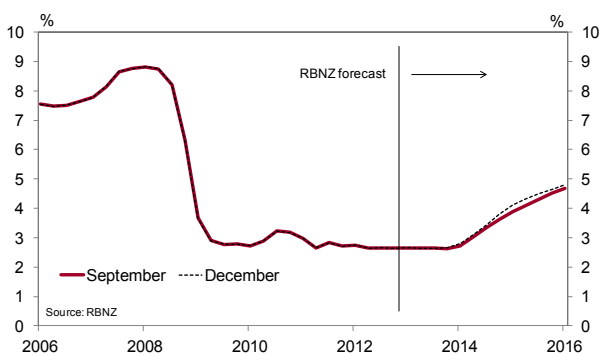
The RBNZ's projections are consistent with an extended series of rate hikes, starting with a 25bp hike in March next year. We accept that March is the best estimate of when the first hike will occur (previously we were forecasting April). That said, we note that the balance of risks are still skewed towards a later start date. It is unlikely that the RBNZ will hike the OCR in January. In contrast, it is possible that weaker-than-expected housing data and a stronger exchange rate could prompt the RBNZ to wait beyond March before hiking.

### The case for hikes

As we saw in the September statement, the RBNZ is increasingly confident that the New Zealand economy has entered a self-sustaining upturn, supported by construction activity in Christchurch and elsewhere, a buoyant housing market and high commodity prices. The latter in particular was given more prominence in today's *MPS*, with a box exploring the possibility that the terms of trade could remain persistently high over the next few years, which would present an upside risk to both interest rates and the exchange rate.

With domestic demand gathering momentum, the stimulus provided by the current low level of interest rates is "becoming unnecessary" (a phrase that appears several times in the document). Higher interest rates will be needed over time to lean against a build-up of domestically-generated inflation pressures, which were seen to have strengthened a little compared to the September forecasts. Consequently,

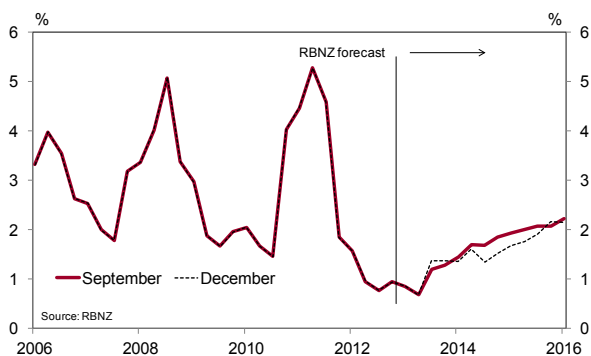
90-day rate – RBNZ forecasts



the RBNZ's short-term interest rate projections were 10-20 basis points higher than in September, with the first increase coming in the March quarter next year.

Notably, the RBNZ was willing to signal a slightly stronger stance on interest rates despite a lower inflation forecast. The change in forecast largely reflects the rebound in the New Zealand dollar over the last few months (with the now-standard assumption that the exchange rate will hold around current levels for the next few quarters before gradually edging lower). Overall inflation is not expected to rise above 2% until the end of 2015.

### CPI inflation – RBNZ forecasts



What we take from this is that the RBNZ is prepared to tolerate weak tradables inflation to some degree, in order to keep non-tradables inflation in check. The RBNZ will be well aware that once domestically-generated inflation gets on a roll, it can be very difficult to bring under control again. RBNZ staff emphasised to us that the current Policy Targets Agreement puts particular emphasis on the 2% midpoint of the inflation target – and that they are aware that there is some work to do on establishing the credibility of that target. Inflation expectations have ticked higher again in the last six months.

Regarding the housing market, the RBNZ delivered a similar message to last month's Financial Stability Report – house price inflation is expected to slow from the second half of 2014, partly due to the LVR mortgage restrictions. At the time it wrote the *MPS*, the RBNZ did not have cause to deviate from that view.

### We now expect the first OCR hike to occur in March 2014, although the risks are skewed towards a later start date.

Overall, the Reserve Bank's stance was very much in line with our expectations. However, the 90-day interest rate forecast indicated that the RBNZ is now targeting a 25 basis point hike at the March *MPS*. Furthermore, we now have the impression that the RBNZ would prefer to begin a hiking cycle with a full *Monetary Policy Statement* rather than at the cut-down OCR Review opportunities.

Accordingly, we have tweaked our OCR forecast. We now expect the first hike will come at the March 2014 *MPS* (previously the April OCR Review). Our longer-run OCR forecasts are unchanged, as they have been since May 2013 – we are still forecasting the OCR to reach 3.5% by December 2014.

There are, however, three important risks that could alter the RBNZ's thinking over the next few months.

First of all, we expect the economy will prove stronger than the RBNZ expects. This would bolster the case for an early OCR hike. The RBNZ's forecast of 1.1% GDP growth in September 2013 looks too light to us – we are forecasting 1.4%. (The figures are released next week.) In addition, net migration could well exceed the RBNZ's forecasts.

However, the second risk would diminish the case for early hikes. The RBNZ is forecasting ongoing house price inflation of above 2% per quarter over the first half of 2014, but we are expecting something significantly weaker. So far, the evidence is in our favour. Real Estate Institute figures released shortly after the *MPS* showed that house sales fell 10% in the first two months after the RBNZ's LVR mortgage restrictions were put in place. And we expect a further decline in house sales to come.

The final risk is perennial – the exchange rate. Our view is that both the US and Australian economies will remain in need of monetary stimulus in coming months, even as it seems ever more likely that New Zealand interest rates are going up. That could well see the New Zealand dollar rise further in early 2014. In turn, a higher exchange rate could cause the RBNZ to go weak at the knees and delay OCR hikes.

So on balance, although we think March is the most likely date for the start of a substantial hiking cycle, the balance of risks is skewed towards a later start date.

### Market reaction

Financial markets went into the statement pricing a risk of a January OCR hike. The tone of the *MPS* made that look unlikely, so short-term interest rates fell on the day. 2-year swap rates were unchanged at first, but rose later in the day. The exchange rate rose half a cent upon the release of the *MPS*, as the RBNZ expressed a fair degree of comfort with the level of the exchange rate.

## **RBNZ media release**

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

Reserve Bank Governor Graeme Wheeler said: “Growth remains moderate but mixed for New Zealand’s main trading partners. Nevertheless, export prices for New Zealand’s main commodities, and especially dairy produce, have continued to increase.

“New Zealand’s GDP is estimated to have grown at over 3 percent in the year to the September quarter and the expansion in the economy has considerable momentum. New Zealand’s terms of trade are at a 40-year high, household spending is rising and construction activity is being lifted by the Canterbury rebuild and the response to the housing shortage in Auckland.

“Continued fiscal consolidation and the high exchange rate will partly offset the strength in domestic demand. The high exchange rate is a particular headwind for the tradables sector and the Bank does not believe it is sustainable in the long run.

“House price inflation is high in Auckland and other regions due to the housing shortage, and demand pressures associated with low interest rates and rising net inward migration. Restrictions on high loan-to-value mortgage lending, introduced in October, should help slow house price inflation. Data to date are limited on the effects of these restrictions. We will continue to monitor outcomes in the housing market closely.

“Annual CPI inflation increased to 1.4 percent in the September quarter and inflation pressures are projected to increase. The extent and timing of such pressures will depend largely on movements in the exchange rate, changes in commodity prices, and the degree to which momentum in the housing market and construction activity spills over into broader cost and price pressures.

“The Bank will increase the OCR as needed in order to keep future average inflation near the 2 percent target midpoint”.

### **Dominick Stephens**

Chief Economist

### **Michael Gordon**

Senior Economist

## Westpac economics team contact details

**Dominick Stephens**, Chief Economist  
+64 9 336 5671

**Michael Gordon**, Senior Economist  
+64 9 336 5670

**Felix Delbrück**, Senior Economist  
+64 9 336 5668

**Anne Boniface**, Senior Economist  
+64 9 336 5669

Any questions email:  
economics@westpac.co.nz

For email address changes contact:  
WNZResearch@westpac.co.nz

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