13 June 2013

Things left unsaid

June 2013 MPS Review: OCR unchanged at 2.50%

- **Today's *Monetary Policy Statement* reiterated that the OCR is likely to remain on hold through the end of this year.**
- **The RBNZ's central scenario was similar to recent statements, striking a balance between a hot housing market and low current inflation.**
- **However, that central scenario assumes an exchange rate much higher than where it is today. If the TWI remains in the low 70s, future RBNZ communications could be more hawkish.**
- **Our view remains that OCR hikes will begin in March 2014, and the OCR will rise further than the RBNZ is forecasting.**

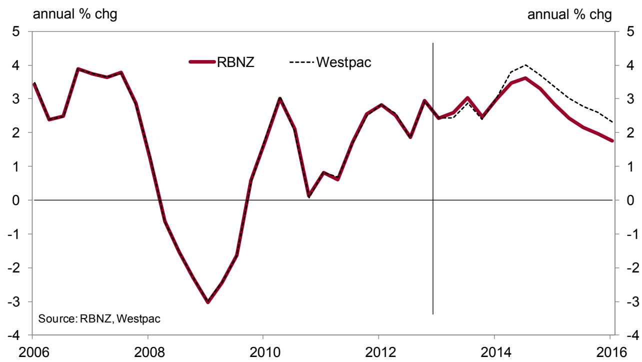
The Reserve Bank delivered another balanced outlook in today's *Monetary Policy Statement*, repeating its message that the OCR is likely to remain on hold until sometime next year. Our concern going into the statement was that the monetary policy message could be muddied by discussion of financial stability measures, such as the loan-to-value ratio limits that the RBNZ has spoken of more favourably in recent weeks. But thankfully today's statement stayed on-topic, focusing on the tension between surprisingly low current inflation and the expectation that inflation pressures will pick up in the future.

The main risk factors for the RBNZ's forecasts are the hot housing market and the high exchange rate. The *MPS* dealt with alternative scenarios where either of them could surprise on the upside, with opposing implications for monetary policy. What was left unstated, though, is that these risks could also go in the other direction, with similar implications. If the housing market cooled because macroprudential regulations were tightened, or if the exchange rate had a sustained fall, the outlook for interest rates would be rather different.

Details

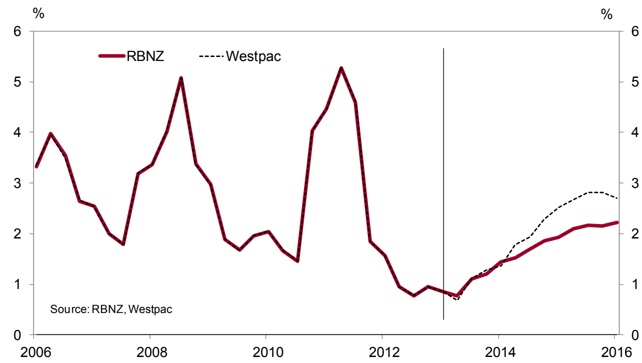
The underlying story of the June *MPS* compared to past missives was one of stronger growth and inflation pressures, largely offset by a higher exchange rate than was assumed in March. The RBNZ expects the economy to grow 2.8% in the year to March 2014 – even with the drought knocking about 0.5% off growth in the first half of this year – and to accelerate to 3.3% in the March 2015 year. Post-quake reconstruction remains a major driver of growth, partially offset by ongoing fiscal tightening.

Fig 1: GDP growth, RBNZ vs Westpac



Inflation remains below the lower bound of the RBNZ's 1-3% target, although the forecasts have future inflation rising more steeply than in previous missives. With inflation remaining subdued in the short term as a result of the strong New Zealand dollar, the RBNZ's interest rate projections continue to suggest no change until the September 2014 quarter, but rise slightly faster from there compared to the March projections.

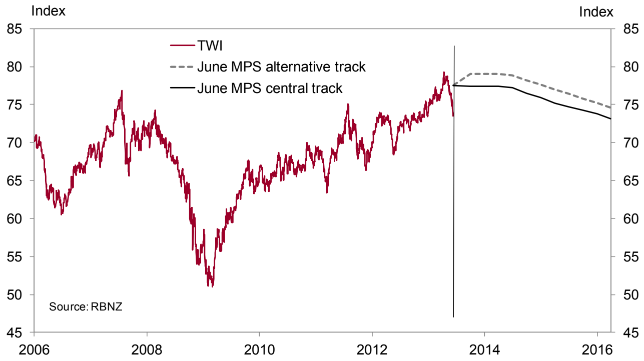
Fig 2: Inflation forecasts, RBNZ vs Westpac



The main tensions around the RBNZ's balanced outlook are the hot housing market and the high exchange rate. Indeed, both factors received the 'alternative scenario' treatment in the *MPS*, with opposing implications for the monetary policy outlook – faster than expected house price inflation would warrant higher interest rates, while a higher exchange rate could warrant rate cuts.

It's the latter scenario that's likely to attract the most interest. It implies that the RBNZ's projections are very sensitive to the level of the exchange rate – in this case, a 2% upside surprise on the trade-weighted index, if sustained, equates to around 100 basis points of OCR cuts over the next year.

Fig 3: TWI, with projected scenarios



Of course, it's not only upside risks that we have to worry about. As of today, the NZ dollar is about 5% lower than the RBNZ's central projection – partly because much of its recent decline on a trade-weighted basis came after the cut-off date for the RBNZ's forecasts. Although the *MPS* can't deal with every contingency, it seems fair to say that the reasoning would also apply in the opposite direction – a lower than expected exchange rate would mean faster growth, more inflation, and higher interest rates than otherwise.

That said, it's not quite that straightforward. There are two conditions under which the RBNZ would respond to a lower exchange rate in this way. The first is that the move would have to be driven by a shift in investor attitudes, not a deterioration in New Zealand's fundamentals. We can safely tick that box – recent market movements have largely been driven by an expectation that the US central bank will scale back its bond-buying programme as the US economy improves.

The second condition is that it would have to be sustained, and there is no guarantee of that. Our own view is that the New Zealand dollar will strengthen later this year, roughly in line with the RBNZ's projections. But forecasting short-term exchange rate movements can be a humbling exercise. If the exchange rate is still lingering around current levels in six week's time, then it will form the base case for the July OCR review – and the RBNZ's tone would become accordingly more hawkish. Even more so if the TWI was still in the low 70s or lower when the September *MPS* rolls around.

We should note that the risks to the housing market outlook aren't one-sided either. The RBNZ's central view is for "the rate of house price inflation to moderate soon", although it adds that "this projection assumes unchanged prudential policy settings". Elsewhere, the RBNZ has made it clear that it is keen to use its macroprudential toolkit – we suspect before the end of this year – to address housing market concerns. If so, house prices could slow faster than projected, and monetary policy would have to take this into account. That said, it's very difficult to anticipate the impact these tools would have on the housing market.

Market implications

The NZ dollar fell 30pts to 0.7930 and the two-year swap rate fell 2 basis points to 3.00%. We suspect that the market was looking for a more hawkish statement on the basis of a lower NZ dollar forecast, not a higher one; if the RBNZ re-ran its forecasts today we suspect they would be more to the market's liking.

Our own view on future interest rates is unchanged. We expect the OCR to remain at 2.5% for the remainder of this year, before rising in March 2014. Eventually, we expect the OCR hiking cycle will be more substantial than the RBNZ is anticipating. There are two key differences of opinion that drive our view. Unlike the Reserve Bank, we expect the Canterbury rebuild will produce just as much inflation pressure as past building booms have done. And unlike the RBNZ, we expect rising house prices to provoke consumer spending in the same fashion as past house price cycles. What it all boils down to is the RBNZ saying "this time will be different", while we disagree.

Full text of 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 global outlook remains mixed with disappointing data in Europe and some other countries, and more positive indicators in the United States and Japan. Global financial sentiment continues to be buoyant and the medium term outlook for New Zealand's main trading partners remains firm."

"Growth in the New Zealand economy is picking up but remains uneven across sectors. Consumption is increasing and reconstruction in Canterbury continues to gather pace and 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 over the past few weeks, the New Zealand dollar remains overvalued and continues to be a headwind for the tradables sector, restricting export earnings and encouraging demand for imports. Fiscal consolidation will continue to constrain aggregate demand over the projection horizon.

"Annual CPI inflation has been just below 1 percent since the September quarter of 2012, largely reflecting falling prices for tradable goods and services. While tradables inflation is likely to remain low, annual CPI inflation is expected to trend upwards through the forecast period.

"Reflecting the balance of several forces, we expect annual GDP growth to accelerate to about 3.5 percent by the second half of 2014, and inflation to rise towards the midpoint of the 1 to 3 percent target band.

"Given this outlook, we expect to keep the OCR unchanged through the end of the year."

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