Westpac

Institutional Bank

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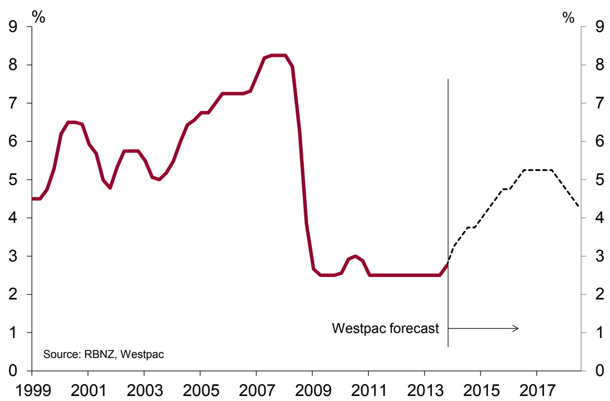
Gear shift

RBNZ to announce a slowdown in the pace of OCR hikes at June MPS

- We have changed our OCR call in response to the high exchange rate, weak inflation data, and yesterday's weak wage numbers.
- We still expect the RBNZ to hike in June.
- But we no longer anticipate a hike in July.
- Instead, we think the RBNZ will slow the pace of hikes to once per quarter, and will deliver hikes in September and December.
- The September election is not a relevant consideration.

Westpac OCR forecast



The Reserve Bank was crystal clear when it issued the March *Monetary Policy Statement* - the 25 basis point hike delivered that day was intended as the first of a long series of hikes. Over two years, the RBNZ expects to lift the OCR by a total of 200 basis points. But the Reserve Bank was equally clear that the pace and extent of hikes would depend on evolving data.

As it happens, the data since March have clearly leaned in the direction of less inflation, and therefore a reduction in the need for OCR hikes.

First, the exchange rate has risen at the same time as New Zealand's terms of trade have deteriorated. That has probably left the RBNZ thinking that it will only need to deliver a total of 175 basis points of hikes by the end of 2015, instead of 200.

Second, March quarter inflation was significantly weaker than expected. True, that mainly represented food price volatility rather than a new trend – underlying inflation is still rising. But it now looks as if inflation will not exceed 2% until the middle of 2015. That reduces the urgency to deliver OCR hikes.

Finally, yesterday's labour market reports will have been comforting to the Reserve Bank. They showed that wage growth remains very subdued despite strong employment growth. The supply of labour has been boosted to match burgeoning demand, thanks to strong net immigration and a record-high labour force participation rate.

Where to from here?

We still expect the RBNZ to hike the OCR in June – that move has been solidly foreshadowed. To back out now would cause "unnecessary volatility in interest rates", which the RBNZ is explicitly instructed to avoid.

If our thinking is correct, after the June *MPS* the RBNZ will feel it has 100bp of hikes left to deliver by the end of 2015, and eighteen months in which to deliver them. Clearly, the RBNZ will need to leave the OCR unchanged at some of its review opportunities. But the risk is that when it does so, markets will overreact. As always, the RBNZ's best strategy is to explain as fully as possible its thinking ahead of time, so that markets are not left guessing about its intentions on the day of an OCR decision.

The opportune moment to signal a slowdown in the pace of hikes would be the June *Monetary Policy Statement.* The text will probably say something to the effect that the pace of future hikes may be slower than the pace to date. The 90-day interest rate forecast might say the same thing. Or perhaps the Governor will just frankly explain that the RBNZ sees the need to hike only once per quarter now, instead of hiking at every OCR review opportunity.

Either way, we think that in June, the RBNZ will make it fairly clear that it does not intend to hike the OCR in July.

In our view, September and December would then become the most likely dates for OCR hikes over the remainder of this year. This is because those dates are full *Monetary Policy Statements* rather than the one-page press releases that accompany OCR Reviews.

Some might argue against a September OCR hike on the basis that the RBNZ will be loath to change the OCR nine days before a general election. The facts say otherwise. In 1999 the RBNZ hiked 50 basis points just ten days before an election. It hiked 25 basis points in the lead up to the 2002 election. And it cut 100 basis points shortly before the 2008 election. There have actually been only two election campaigns during which the OCR remained on hold! The RBNZ will be a political football whatever it does at election time. The best strategy is to signal its intentions clearly ahead of time, and ensure that the decision on the day is well reasoned and solidly justified – the same as any OCR decision, really.

Our longer-term interest rate views have been broadly unchanged since May 2013, and so they remain. To control the inflationary pressures emanating from the Canterbury rebuild and recent house price inflation, we believe the RBNZ will have to hike the OCR substantially over the coming three years. However, we have tweaked our forecast of the peak OCR down to 5.25%, instead of 5.5%, in response to signs that the New Zealand economy is able to handle more growth without inflation pressure than we had previously given it credit for. We will discuss this last point more when we release our *Quarterly Economic Overview* next week.

Dominick Stephens
Chief 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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