Westpac

Institutional Bank

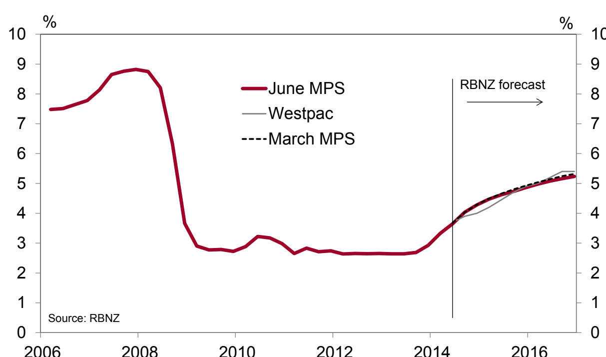
12 June 2014

Now for the tough choices

June 2014 MPS Review: OCR increased to 3.25%

- The Reserve Bank today increased to OCR from 3.00% to 3.25%, and provided much the same guidance on future interest rates as in its March *Monetary Policy Statement.*
- The statement came as a surprise to markets, which had been expecting a downgrade to the RBNZ's interest rate projections.
- Dairy export prices have softened, but construction remains a strong driver, net migration is surging, and global forces have brought key mortgage rates down.
- We now expect the next OCR hike to come in July (previously September). But it's a close call, and more subject to the flow of data and the evolution of financial markets than previous OCR decisions were.

90-day rate, RBNZ projections



The Reserve Bank today increased the OCR for a third consecutive time to 3.25% and delivered almost the same guidance on future interest rate hikes as in its March *Monetary Policy Statement (MPS).* We had been warning beforehand that the balance of risks hadn't shifted as much as markets seemed to think, but even we were a little surprised by how firmly the RBNZ held its line.

If there was any softening of tone, it was only to the extent that the RBNZ is now further down the path that it laid out in March. The RBNZ's projections, both then and now, suggested about 200 basis points of tightening over two years; with 75 basis points already under its belt, each subsequent OCR review becomes a little less pressing and more contingent on the flow of data.

That said, our reading of today's statement is that the RBNZ's base case is for a fourth consecutive hike at the July OCR review, and the onus is on the data to persuade it otherwise. Hence, we've brought forward our forecast of the next hike from September to July – though we always recognised this as a close call, and it still is.

How that uncertainty is resolved over the next six weeks will depend on upcoming data (including GDP next week and inflation on 16 July) and the evolution of commodity export prices, the exchange rate and fixed-term mortgage rates. And, if market opinion remains divided ahead of the July review, we wouldn't be surprised if the RBNZ gave some guidance via a speech or two, a channel that the RBNZ is increasingly using.

Details

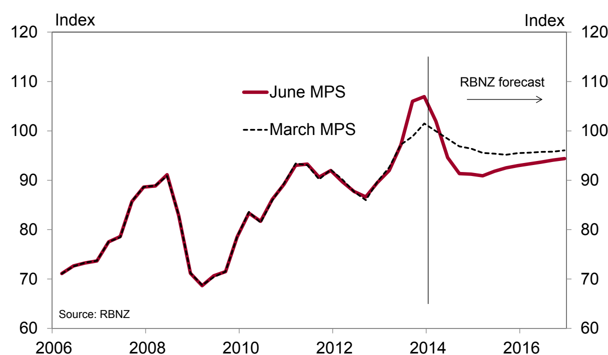
The RBNZ's latest interest rate projections were almost identical to the March *MPS* – a track that suggests a cash rate of 3.75% by the end of this year and around 4.5% next year. That in turn implies another OCR hike by September this year, and quite plausibly before then. Beyond the September quarter, the pace of tightening is expected to become more gradual.

The economy is in a strong and broad-based upturn, growing at a 4% annualised pace over the second half of 2013, and the RBNZ expects that this pace was maintained over the first half of this year. Building activity both in Christchurch and elsewhere is a key driver of growth, strong net inward migration is seen to be boosting consumer spending and house prices, and business and consumer confidence remain very high. The RBNZ judges that GDP is already running 1% above its non-inflationary potential, and that the gap will widen further this year.

Even so, the RBNZ still expects inflation to remain low over the next three years, and has actually lowered its near-term inflation forecasts since March, due to a weaker starting point (March quarter inflation was softer than expected) and a higher exchange rate. Interestingly, the RBNZ noted that it is required by law to consider monetary policy and inflation outcomes as much as five years ahead. There is a good case for tolerating low inflation for a few years if it helps to keep inflation processes in check over a longer horizon. It is very encouraging to see the central bank thinking so far ahead.

One of the more significant changes to the RBNZ's views since March – and the one that the market seemed to be fixated upon beforehand – was a downgrade to its export price forecasts, reflecting the steep fall in world dairy prices in the last few months. While the fall has been greater than the RBNZ expected in March, it's also worth noting that prices have peaked at a higher level than the RBNZ thought. Furthermore, meat prices have been steadily rising. The net result was only a modest downgrade to the RBNZ's assumption about the long-term level of export prices.

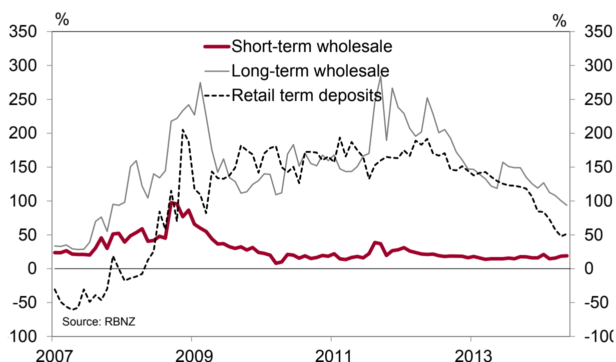
Goods export prices, RBNZ projections



Against this substantial negative factor, there were a number of positive surprises for the RBNZ. Fiscal policy (making its first appearance in the RBNZ's media release for quite a while) is less of a restraining factor now, due to the spending increases signalled in the May Budget. Net inward migration is tracking stronger than previously expected; recent RBNZ research has asserted a strong link between net migration and house price inflation, with the result that the RBNZ has actually upgraded its expectation for a resurgence in house prices over the second half of this year.

And perhaps most significantly, term interest rates are behaving in a very different way to what the RBNZ would have anticipated. It's not simply a local issue: a fall in global long-term interest rates has dragged rates down here as well. And on top of this, the risk premiums charged by international lenders have continued to narrow; while they're not yet back to pre-GFC levels, they are now a long way from their peaks. In New Zealand, these forces have manifested as a fall in some popular fixed-term mortgage rates, which risks re-stimulating the housing market.

Bank funding margins (spread to OCR)



The RBNZ clearly has some concern about this trend – its media release noted that "the speed and extent to which the OCR will need to rise will depend on future economic and financial data" (our emphasis). There's no sense that the RBNZ believes that it can combat this trend, given its global origins. But – like a more stimulatory fiscal policy – it forms part of the backdrop against which the central bank makes it interest rate decisions. Lower funding spreads would mean that the OCR has to do more of the tightening work. Alternatively, if fixed-term mortgage rates were to rebound in coming weeks, the case for a July OCR hike would diminish.

Market implications

Financial markets were fully priced for today's 25bp hike, but opinion beforehand seemed to be split between whether the RBNZ would lower its interest rate projections by a little or a lot. With no downgrade at all forthcoming, the market reaction to the *MPS* was strong. The two-year swap rate rose six basis points, and the New Zealand dollar rose three-quarters of a cent against the US dollar.

As mentioned earlier, we believe that the balance of risks is now slightly skewed towards a July OCR hike. The *MPS* projections were more or less the same as in March (when we felt that a July hike was most likely), and there was nothing in the RBNZ's language today that would suggest a slowing in the pace of tightening just yet. Our view remains that this will be followed by one hike in the December quarter, then proceeding gradually to a peak of 5.25% by the end of 2016.

RBNZ media release

The Reserve Bank today increased the Official Cash Rate (OCR) by 25 basis points to 3.25 percent.

New Zealand's economic expansion has considerable momentum, with GDP estimated to have grown by around 4 percent in the year to June. Global financial conditions remain very accommodative and are reflected in low long-term interest rates and narrow risk spreads. Economic growth among New Zealand's trading partners is gradually improving and global inflation remains low.

Prices for New Zealand's export commodities remain historically high, but their recent falls will reduce farm incomes over the coming year. A continued acceleration in construction in Canterbury, and more broadly, is supporting growth, together with strong net immigration flows that are adding to housing and household demand. Business and consumer confidence remains buoyant, as do businesses' reported intentions to invest and to hire.

While house price inflation remains high, the housing market has moderated since late last year when restrictions were applied to high loan-to-value ratio mortgage lending and when mortgage interest rates began rising. Fiscal consolidation continues to moderate demand growth, though by less than previously assumed. The exchange rate has not yet adjusted to weakening commodity prices, but is expected to do so. The Bank does not believe the exchange rate is sustainable at current levels.

Headline inflation remains moderate and tradables inflation is expected to be low for some time. However, above-trend growth has been absorbing spare capacity and adding pressure to non-tradables inflation. These pressures are particularly evident in construction cost increases. Nevertheless, overall wage inflation remains moderate, reflecting recent low headline inflation, increased labour force participation and strong net immigration.

Inflationary pressures are expected to increase. In this environment, it is important that inflation expectations remain contained and that interest rates return to a more neutral level. The speed and extent to which the OCR will need to rise will depend on future economic and financial data, and its implications for inflationary pressures.

By increasing the OCR as needed to keep future average inflation near the 2 percent target mid-point, the Bank is seeking to ensure that the economic expansion can be sustained.

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