Westpac

Institutional Bank

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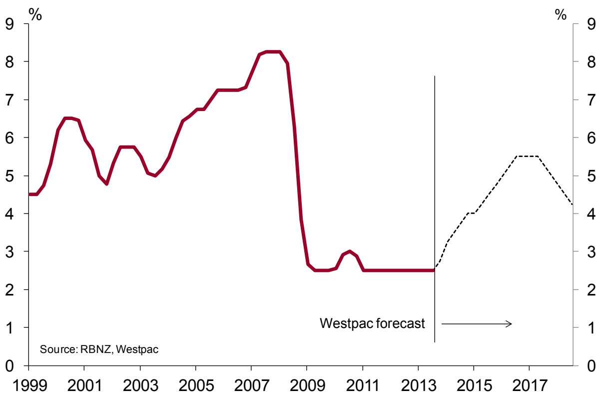
Curtain raiser

OCR Preview, January 2014

- The economic situation warrants hiking the OCR this year.
- The remaining question is whether the RBNZ will move next week or wait until March.
- The March MPS comes with vastly superior opportunities to communicate and justify a hiking decision – something the RBNZ values highly.
- We conclude that the RBNZ will leave the OCR on hold next week, but will signal a March hike.

Westpac OCR forecast



On Thursday next week the Reserve Bank will review the Official Cash Rate for the first time in 2014. The outcome will be expressed as a single-page press release, with no accompanying *Monetary Policy Statement* or press conference.

In its last missive, the RBNZ gave itself the green light to hike by saying it would "increase the OCR as needed". Its forecasts implied four or five hikes over 2014, beginning in March or April.

Next week, we expect the RBNZ will keep the OCR unchanged at 2.5%, but will send a clear signal that it intends to hike the OCR at the March *Monetary Policy Statement.* The key sentence of the press release might be similar to the wording used on the eve of the last set of OCR hikes, back in April 2010:

"We expect to begin removing policy stimulus over the coming months, provided the economy continues to evolve as projected."

If the RBNZ follows our prescription, market reaction will be muted. By contrast, if the RBNZ does hike next week the market reaction will be large. The two-year swap rate could rise by 10 to 20 basis points, and the New Zealand dollar could appreciate by around a cent. So it is well worth considering the arguments for and against a January hike.

All the evidence we need

The flow of recent data in New Zealand certainly does make it clear that the OCR needs to go up this year. The economy was probably expanding at greater than 1% per quarter over the second half of 2013. Business confidence is at multi-decade highs. The terms of trade remain at their highest level since the early-1970s. And inflation is rising more quickly than expected, although it is still below the RBNZ's 2% target.

Our key theme for the past couple of years has been that the Canterbury rebuild combined with rising house prices would boost GDP growth and generate inflation pressures that require a substantial hiking cycle from the Reserve Bank. Our long-held forecast is now coming to pass.

True, the exchange rate is high and the housing market is slowing. But neither is much different to what the RBNZ expected at the time it laid out its plan to hike the OCR gradually over 2014.

Why dally?

With data like this, a strong case could certainly be mounted for hiking the OCR next week. It is certain the RBNZ will consider that option, and it might be a close call. But we think it is more likely that the RBNZ will opt to wait until March before actually hiking.

The benefit of hiking in January is that interest rates will get to where they need to be more promptly. But this benefit is only slight. If the central bank's intentions are clearly and credibly signalled, financial markets should lift term interest rates well in anticipation of a hiking cycle, achieving many of the RBNZ's goals early. This is exactly what has happened in the current cycle – term interest rates have already risen substantially.

Admittedly, the floating mortgage rate is important, and is tied to the OCR. Lifting it now would be better – but waiting an extra six weeks is not dramatically inferior.

If the economic benefit of hiking now is slight, the communications benefit of waiting until March is substantial.

Next week's OCR Review consists of just a one-page press release. By contrast, the March MPS is backed up by a five-chapter booklet, economic forecasts including a forecast of interest rates, a press conference, and an appearance before parliament's Finance and Expenditure Committee. Just over a month ago the RBNZ underlined its deep commitment to transparency, saying it saw clear communication as vital to effective policy making. Beginning a hiking cycle with a full *Monetary Policy Statement* is in keeping with such a focus on transparency and communication – a surprise hike accompanied by a one-page press release is not.

Increasing interest rates inevitably cops criticism in a debtor nation like New Zealand. This is a serious issue for the RBNZ, as large chunks of the political spectrum are hostile to the monetary policy framework. The central bank has already made itself unpopular in some circles with its high-LVR mortgage restrictions, and is probably keen to avoid further acrimony.

Hiking in January would give the RBNZ's critics more ammunition. A January hike would take the public by surprise, and might seem the actions of a maverick central bank acting without consensus or comprehensive analysis. By contrast, in March the Governor could cite the plethora of analysis and explanations that go into a full *Monetary Policy Statement.* He could note that all private sector forecasters predicted and recommended a March hike (not true of January). And he could (presumably) cite the informed support of the two external advisors on the Monetary Policy Committee (who do not attend the meetings preceding OCR Review decisions). A March hike would be a consensus decision, unlike January.

Perhaps more important, January's one-page press release would give the RBNZ very little opportunity to respond to any criticism. The critics could gain sway in the media, while the RBNZ itself would be mute until the next speech opportunity. By contrast, the RBNZ could grab the initiative in March via its press conference and the fuller explanations in the *Statement.*

A January hike would also risk generating financial market volatility, which the RBNZ is explicitly instructed to avoid. Without explicit guidance on future hikes, markets could easily extrapolate from a January hike and send term interest rates higher than the Reserve Bank intends. In turn, this would lead to a large increase in the exchange rate. The central bank would have to work to unwind any such overreaction later.

By contrast, signalling imminent hikes in January and then pulling the trigger in March would be a path to smaller financial market reactions. The RBNZ could be quite precise about the shape of the OCR hiking cycle it envisages at the full March *Monetary Policy Statement*¸ and would be more certain that term interest rates will land at the intended level.

The RBNZ has little to gain by hiking in January, and much to lose. A poorly communicated hike risks market volatility and is a gimme to the RBNZ's detractors. The least-regrets option is to wait until the full March *Monetary Policy Statement.*

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