Westpac

Institutional Bank

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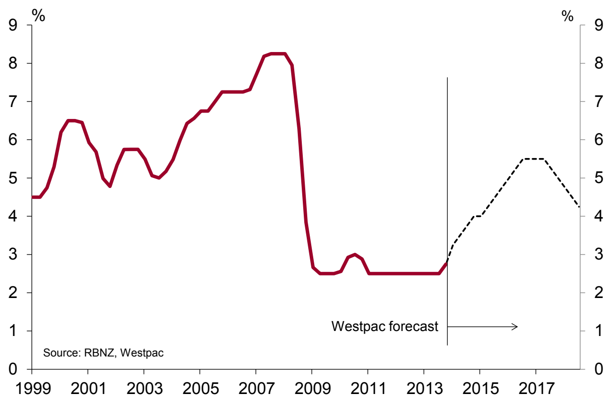
Variations on a theme

OCR Review, April 2014

- As expected the RBNZ hiked the OCR from 2.75% to 3.00%.
- The commentary was a virtual repeat from March, except that the high exchange rate got more emphasis.
- We firmly expect the RBNZ to follow up with a June hike.
- And there is a reasonable chance of yet another hike in July.
- We believe the RBNZ is now aiming for 175bp of hikes over two years.

Westpac OCR forecast



The Reserve Bank increased the OCR to 3.00%, as unanimously expected by economists and financial markets. Also as expected, the accompanying one-page press release acknowledged the high exchange rate, but was otherwise a virtual repeat of the March press release. The main message is still that the OCR is going to rise over the next couple of years.

As there were no major surprises in this OCR Review, our expectations for the OCR have not changed. It remains clear that RBNZ intends to deliver another 25 basis point hike in June.

We have pencilled in further hikes of 25 basis points each for July and December this year. However, we admit that the high exchange rate makes the July hike a very close call.

Judging by the tone of today's press release, the RBNZ feels the same way. The RBNZ signalled 200 basis points of OCR hikes over two years when it published the March *Monetary Policy Statement.* But because the exchange rate has subsequently moved higher, the RBNZ is probably now thinking that only 175 basis points will be necessary. Absent any major surprises, the RBNZ will use the June *Monetary Policy Statement* to signal this slight moderation to the outlook for the OCR.

The RBNZ will no-doubt also use the June *MPS* to clarify whether or not it intends to hike in July. Which way it leans is a fifty-fifty call. We are plumping for a June *MPS* that does signal a July hike. But we admit there is a strong chance that instead, the RBNZ will use the June *MPS* to announce a pause in the tightening cycle. In the latter scenario the next OCR hike would be delayed until September or October (with the timing of the election playing no role in the decision).

The press release, blow by blow

The RBNZ chose to use the press release from the March *MPS* as a template for today's press release. Entire sentences were repeated word for word – in some cases entire paragraphs. This is significant – it furthers the impression that the RBNZ has firmly set its course, and has today varied only the details.

By the same token, any alterations that did appear must have been deliberate, and are worthy of analysis.

In the first paragraph, the RBNZ estimated that GDP growth was 3.5% in the year to March (3.3% in the March *MPS*). This implies that the RBNZ has not changed its GDP growth forecast beyond acknowledging the small upside surprise in the December GDP figures.

Also in the first paragraph, the RBNZ chose to mention low global inflation (which did not rate a mention in March). Low global inflation carries a range of implications for New Zealand, from lower local inflation to a higher exchange rate – all of which point in the direction of fewer OCR hikes.

In the second paragraph, the RBNZ noted that auction prices for dairy products had fallen 20% in recent months, although it chose not to elaborate on the implications. We were not particularly surprised by the drop in dairy prices, and we don't think the RBNZ was either.

Also in the second paragraph, the RBNZ said that net immigration "continues to increase" (in March it said net immigration had increased "over the past 18 months"). Further down, the RBNZ shuffled the words concerning the impact of net immigration on the housing market around slightly. By our reckoning, net immigration has been slightly stronger than the RBNZ anticipated – and it does appear as though the RBNZ is giving the barest of nods in that direction. However, the overall significance of these changes seems slight.

The RBNZ pointedly snubbed recent weak inflation data, by leaving its commentary on inflation virtually unchanged relative to the March *MPS*. This time the RBNZ said "Headline inflation is moderate, but inflationary pressures are increasing and are expected to continue doing so over the next two years" (In March it said "While headline inflation has been moderate, inflationary pressures are increasing and are expected to continue doing so over the next two years"). This serves to emphasise that the RBNZ is focussed on future inflation on average over the medium term, not the latest blip in the headline figures.

The most significant change to the press release came in the all-important sentence regarding future changes in the OCR. The first part of the sentence was a simple repeat of the March phrase: "The speed and extent to which the OCR will be raised will depend on economic data and our continuing assessment of emerging inflationary pressures,". However, the RBNZ went on to deliberately heighten the focus on the exchange rate by appending a new phrase: "including the extent to which the high exchange rate leads to lower inflationary pressure."

Full RBNZ statement

The Reserve Bank today increased the OCR by 25 basis points to 3 percent.

New Zealand's economic expansion has considerable momentum, with GDP estimated to have grown by 3.5 percent in the year to March. Growth is gradually increasing in New Zealand's trading partners, but inflation in those economies remains low. Global financial conditions continue to be very accommodating.

Prices for New Zealand's export commodities remain very high, though auction prices for dairy products have fallen by 20 percent in recent months. Domestically, the extended period of low interest rates and strong growth in construction sector activity are supporting the recovery. Net immigration continues to increase, boosting housing and consumer demand. Confidence remains very high among households and businesses, and measures of investment and employment intentions are positive.

Spare capacity is being absorbed, and inflationary pressures are becoming apparent, especially in construction and other non-tradable sectors. The high exchange rate remains a headwind to the tradables sector, and along with low import price inflation has been holding down tradables inflation. The Bank does not believe the current level of the exchange rate is sustainable.

There has been some moderation in the housing market. Restrictions on high loan-to-value ratio mortgage lending are easing pressure, and rising interest rates will have a further moderating influence. However, the increase in net immigration is adding to housing demand.

Headline inflation is moderate, but inflationary pressures are increasing and are expected to continue doing so over the next two years. In this environment it is important that inflation expectations remain contained. To achieve this it is necessary to raise interest rates towards a level at which they are no longer adding to demand. The speed and extent to which the OCR will be raised will depend on economic data and our continuing assessment of emerging inflationary pressures, including the extent to which the high exchange rate leads to lower inflationary pressure.

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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