Institutional Bank

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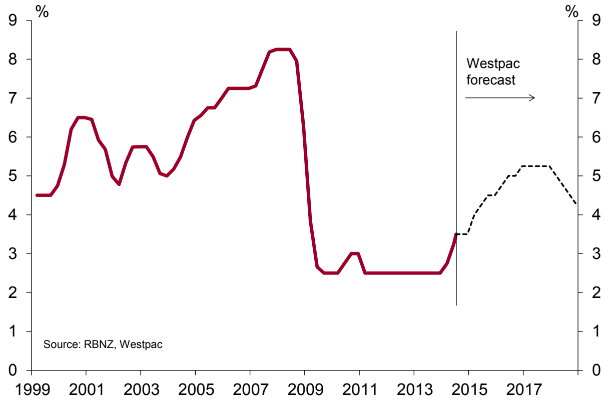
The tortoise versus the hare

RBNZ OCR Review, July 2014

- This OCR Review was very much in line with our expectations.
- The RBNZ hiked the OCR to 3.5% and signalled a pause. We think the pause will last until January 2015.
- The RBNZ reiterated its broad intention to hike the OCR over the coming years.
- The press release was littered with references to the more moderate inflation outlook, meaning the required pace of OCR hikes may now be slower than previously signalled.
- We suspect interest rate markets are going to overreact to this pause signal. The result may be an unintended drop in fixed mortgage rates.
- There was a direct warning of possible exchange rate intervention. We ascribe a significant probability to intervention within the next month.

Westpac OCR forecast



Like the hare in the famous race against the tortoise, the RBNZ bolted out of the starting blocks with OCR hikes and is now going to take a snooze.

As expected by Westpac and other economists, at today's Official Cash Rate Review the Reserve Bank of New Zealand hiked the OCR to 3.5% but announced that the OCR hiking cycle is now entering a temporary pause phase.

The RBNZ reiterated its broader intention is to lift the OCR over the coming years. But judging from the tone of the press release, the expected pace of hikes may now be slightly more moderate than that signalled in the June *MPS*. Perhaps the RBNZ is now aiming to have the OCR at 4.5% by June 2016, rather than the 4.75% it forecast in the June *MPS*.

There was nothing in today's release to cause a change in our OCR forecast. We expect that the pause phase will last until January 2015. We anticipate four OCR hikes during 2015, and we anticipate an eventual peak OCR of 5.25%.

Observing the way interest rate markets are behaving, we sense the beginnings of an overreaction to today's pause signal. Market pricing is now consistent with just two OCR hikes between now and December 2015, and interest rates could fall further from here. Whereas the RBNZ intends this to be a hiatus within a broader trend of a rising OCR, markets are starting to doubt the entire nature of the hiking cycle. The risk is that fixed mortgage rates will fall to levels that make the RBNZ uncomfortable. If that does happen, the RBNZ will have to "correct" market pricing during one of its many speeches, by reiterating its broader intention to normalise the OCR.

In our view it was not necessary to risk creating such volatility in interest rates. Tortoise-like behaviour might have been better. As we said prior to the June *MPS*, we think the RBNZ would have been better served by signalling a slower but steadier pace of hikes at that stage.

A risk of currency intervention

Today's press release strengthened our conviction that the RBNZ could intervene in foreign exchange markets by selling New Zealand dollars any day now. The RBNZ riled against the inconsistency between tumbling export commodity prices and the very high exchange rate by saying *"the level of the New Zealand dollar is unjustified and unsustainable and there is potential for a significant fall."* We interpret this choice of language as a direct warning of intervention.

The reaction on foreign exchange markets was vigorous. The NZD/USD exchange rate fell from 87c to 86c, and could fall further. This reaction struck us as entirely sensible – indeed, we are forecasting the NZD/USD to average 83 cents over the remainder of 2014.

The press release blow-by-blow

The RBNZ made it clear that it is now moving into a temporary 'pause' phase with the following comment in the penultimate paragraph of the press release:

"Encouragingly, the economy appears to be adjusting to the monetary policy tightening that has taken place since the start of the year. It is prudent that there now be a period of assessment before interest rates adjust further towards a more-neutral level."

The first part of that statement effectively rules out any OCR hike in September or October. But the last part is a reminder that the RBNZ has retained its intention to hike the OCR over the coming years. Indeed, the description of the long-run OCR outlook was similar to previous releases:

"The speed and extent to which the OCR will need to rise will depend on the assessment of the impact of the tightening in monetary policy to date, and the implications of future economic and financial data for inflationary pressures."

The press release was littered with references to the weaker economic data New Zealand has experienced. For example, *"dairy and timber prices have fallen and these will reduce primary sector incomes over the coming year"*, *"house price inflation has moderated further since June"*, and *"wage inflation is subdued"* (the RBNZ previously described wage growth as moderate). Interestingly, the RBNZ felt that the weakness in recent global economic data would prove temporary.

Meanwhile, the RBNZ's language around net migration was no different to previous releases, despite recent upside surprises in the migration data.

The overall tone of the press release was also more moderate on inflation than previous communiques. Whereas the RBNZ previously said strong economic growth "has been" adding to non-tradables inflation, it now said this process was "expected" to happen. This was a reference to the lack of acceleration in construction-related inflation in last week's inflation numbers.

Full press release

The Reserve Bank today increased the Official Cash Rate (OCR) by 25 basis points to 3.5 percent.

New Zealand's economy is expected to grow at an annual pace of 3.7 percent over 2014. Global financial conditions remain very accommodative and are reflected in low interest rates, narrow risk spreads, and low financial market volatility. Economic growth among New Zealand's trading partners has eased slightly in the first half of 2014, but this appears to be due to temporary factors.

Construction, particularly in Canterbury, is growing strongly. At the same time, strong net immigration is adding to housing and household demand, although house price inflation has moderated further since the June *Statement*.

Over recent months, export prices for dairy and timber have fallen, and these will reduce primary sector incomes over the coming year. With the exchange rate yet to adjust to weakening commodity prices, the level of the New Zealand dollar is unjustified and unsustainable and there is potential for a significant fall.

Inflation remains moderate, but strong growth in output has been absorbing spare capacity. This is expected to add to non-tradables inflation. Wage inflation is subdued, reflecting recent low inflation outcomes, increased labour force participation, and strong net immigration.

It is important that inflation expectations remain contained. Today's move will help keep future average inflation near the 2 percent target mid-point and ensure that the economic expansion can be sustained. Encouragingly, the economy appears to be adjusting to the monetary policy tightening that has taken place since the start of the year. It is prudent that there now be a period of assessment before interest rates adjust further towards a more-neutral level.

The speed and extent to which the OCR will need to rise will depend on the assessment of the impact of the tightening in monetary policy to date, and the implications of future economic and financial data for inflationary pressures.

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