

Walking the path

July 29 OCR preview: RBNZ to hike 25bps to 3.00%

- **We expect another 25bp hike at next Thursday's OCR review, with a slightly more subdued statement compared to June.**
- **Recent economic data has been on the soft side of expectations, but not enough to divert the RBNZ from its stated intention to normalise interest rates over the next couple of years.**

Since the June *Monetary Policy Statement*, the economic news has generally been on the weaker side of expectations – not hugely so, but the disappointments have been widespread. That will probably bring a more subdued tone to the language of next week's OCR statement, but the intent to return rates to more normal levels over the next two years will remain intact.

Economic conditions

In terms of the major data releases (which we can compare directly to the June *MPS* forecasts), two have undershot slightly and one was stronger. First, March quarter GDP grew by 0.6% against the RBNZ's forecast of 0.8%, with the difference likely coming from a subdued consumer. Top-down indicators to date suggest that the June quarter will also fall short of the RBNZ's previous forecast of 1.1%.

June quarter CPI was also lower than expected, taking the annual inflation rate down to 1.8%, although the RBNZ will take some mixed messages from the details. Food prices have fallen, and the strength of the NZ dollar over the last year is still being passed through to the prices of many tradable goods. However, non-tradables prices (in particular housing-related costs) rose by more than they expected.

On the plus side, the export sector continues to benefit from high commodity prices and solid demand growth. That saw the current account deficit narrow to 2.4% of GDP, much lower than the RBNZ forecast of 3.3% (with about half of the surprise coming from the trade surplus). So all together, the data points to a continued rebalancing of the economy, with the contrast between weak consumption and strong production even greater than thought.

More frequent data has pointed to subdued retail spending, a weak housing market, and slowing net migration inflows (the latter perhaps contributing to the first two). Business confidence has dipped recently, but it remains at levels that are consistent with recovery.

Financial developments since June have been mixed. The NZD trade-weighted index has averaged about 3% higher than the RBNZ assumed, but global credit market conditions have been steadily improving. The June OCR hike was not fully reflected in short-term mortgage rates, and fixed-term rates for two years or more have actually fallen outright.

Statement

Next week's statement is likely to be peppered with references to flat or weaker economic conditions compared to June. However, we think that the 'bias' paragraph – the crucial message from the market's point of view – will be left largely intact. In June that paragraph read:

"Given this outlook and as previously signalled, we have decided to begin removing some of the monetary policy stimulus that is currently in place. The further removal of stimulus will be reviewed in light of economic and financial market developments."

Keeping the first sentence would hark back to the June *MPS* projections, which pointed to the OCR rising from a low of 2.5% to a more 'neutral' level of 5.5-6.0% over the next two years. The RBNZ has spent many months making the case that interest rates will need to be normalised as the economy improves. There is nothing in the recent data that would warrant a change to the end-point of that plan, though it perhaps argues for less front-loading of hikes.

The phrase "removal of stimulus" will definitely be retained – the RBNZ has tried to deflect criticism by portraying rate hikes as taking the foot off the accelerator rather than hitting the brakes.

Finally, the last sentence of the paragraph was fairly non-committal for a central bank projecting 300 basis points or more

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of hikes over the next two years. We think it was meant to imply “don’t automatically assume another hike in seven weeks”, and that seems like a reasonable message to convey this time as well – even if a follow-up hike is more likely than not.

Market implications

Interest rate markets have fully factored in a 25bp hike next week, and pricing for the next year is broadly in line with the RBNZ’s June projections – a touch lower if anything. We expect that a 25bp hike with an unchanged ‘bias’ would see a modest rise in wholesale interest rates (no more than 5bps). The NZD remains beholden to sentiment in global equity markets, so the OCR decision is unlikely to have a sustained impact.

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