20 April 2012

Westpac Institutional Bank

# Whittled down

## April 26 OCR Preview: RBNZ on hold at 2.50%

- **We anticipate a modestly dovish OCR review from the Reserve Bank.**
- **The RBNZ's slight hiking bias will be whittled away further.**
- **We now expect the first OCR hike will be delayed until March 2013.**
- **In contrast to the RBNZ, we are forecasting an extended series of OCR hikes from 2013 to 2015.**

### Summary

Back in mid-2011 the Reserve Bank was warning that a sharp series of OCR hikes was imminent. Since then the Bank has softened its stance at each successive OCR review or Monetary Policy Statement. Initially the European sovereign debt crisis gave pause for thought. Later, surprisingly low inflation and the high exchange rate had the Reserve Bank lowering its forecast for future interest rates. By March this year the putative hiking cycle had been whittled down to almost nothing – just one OCR hike per year.

We expect the Reserve Bank will once-again soften its stance at next week's OCR review. The final paragraph of the press release, which is usually the "bottom line" both figuratively and literally, will probably be a repeat from the March MPS:

*"Given the outlook for inflation, it remains prudent to leave the OCR on hold."*

However, compared to the March MPS we expect the other paragraphs of next week's press release will tend in the direction of keeping the OCR low for longer.

First up, the Reserve Bank will waste no time in pointing out that inflation has now fallen into the lower part of its 1% to 3% target range, rather than having *"settled near the middle"* as it said in the March MPS.

In March the RBNZ commented that "The domestic economy is showing signs of recovery." That's still true, but the pace of recovery has been slower than expected. December quarter GDP was weaker than the RBNZ forecast, and it looks as though the March quarter will similarly disappoint. To be sure, some forward-looking data has been impressive. The housing market is going from strength to strength, confidence surveys suggest the economy has accelerated in recent months, and the Canterbury rebuild is clearly swinging into gear. But these positive data merely affirm the RBNZ's forecast of rapidly accelerating GDP. They don't represent a surprise to the central bank.

Next week's press release might make direct reference to ongoing declines in NZ export commodity prices, which the Reserve Bank did not anticipate. And commentary on the global economy will surely be downbeat, given the recent run of weaker data in the US and China and fresh worries about financial stability in Europe.

Finally, we expect the fire and brimstone warnings about the detrimental effect of the high exchange rate to be repeated, or even intensified. In March the Reserve Bank fumed that "the high value of the New Zealand dollar is detrimental to the tradable sector, undermines GDP growth and inhibits rebalancing in the New Zealand economy," and concluded that "sustained strength in the New Zealand dollar would reduce the need for future increases in the OCR." Since then, the economic backdrop has weakened but the exchange rate has remained stubbornly high.

### We have changed our OCR forecast

Over the past six weeks we've had an accumulation of small surprises that all argue in the direction of keeping the OCR low for longer. Consequently, we have changed our OCR forecast. We now expect the first OCR hike will come in March 2013. Come September, a new RBNZ governor will inherit an "on hold" stance and a headline inflation rate in the lower half of the target band. Even if the economy is accelerating and house prices are rising, the new governor may not need to change direction as early as the December MPS. Rather, s/he can use that opportunity to establish his/her credentials, leaving OCR hikes until 2013.

However, we continue to believe that the eventual OCR hiking cycle will extend far further than the Reserve Bank is signalling, for two main reasons. First, we disagree with the Reserve Bank's notion that the Christchurch rebuild can be undertaken without the inflation pressure that usually follows construction booms. And we are not so sure that the "neutral OCR" has fallen as far as the RBNZ believes.

### Market implications

A modestly-dovish press release along the lines we have outlined above would probably elicit little reaction from financial markets, which are already anticipating a more delayed start to OCR hikes. Only if the RBNZ floated the possibility of OCR cuts would the market react strongly, but at this stage we regard that as an unlikely scenario.

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