Westpac Institutional Bank

Yes. No. Maybe.

July 28 OCR review: OCR unchanged at 2.5%, RBNZ signals earlier hikes.

- **The OCR remained at 2.50%, as expected.**
- **The RBNZ signalled 50bp of OCR hikes in the near term, conditional on global financial risks receding.**
- **Beyond that, the RBNZ sounded a rather dovish tone due to concern about the high exchange rate.**
- **We are now calling two 25bp hikes, one in September and one in October, before a pause in December.**
- **We maintain our long-held forecast that the OCR will rise gradually over the next three years, to a peak of 6%.**

The Reserve Bank today kept the OCR on hold at 2.5%, and issued a rather nuanced interest rate outlook. The upshot is that the RBNZ is planning 50 basis points worth of hikes in the near term, followed by a pause. But the early hike(s) are conditional on the domestic economy continuing to recover (which seems likely), and global financial risks receding (which is less certain).

We believe the most likely scenario is two 25bp OCR hikes, one in September and one in October, before a pause in December. A 50bp hike in September is distinctly possible, should global financial concerns about US and European sovereign debt abate. But that's far from certain at this juncture. Indeed, a significant deterioration in financial market sentiment could yet delay the early hikes altogether.

The first two paragraphs of the RBNZ's short media release were quite dovish. Recent improvements on the domestic economic front were acknowledged, but were countered by fragility in global financial markets and the risk of slower growth among our trading partners. Near-term inflation was largely dismissed by the assertion that underlying inflation remains below 2.5%.

But the final paragraph gave as clear a signal as any that the RBNZ expects to hike the OCR soon:

"Provided current global financial risks recede and the economy continues to recover, the Bank sees little need for the March 2011 'insurance' cut to remain in place much longer."

Referring to the 50 basis point March 'insurance' cut even gave a rare indication of the magnitude of the expected move, although it is not clear whether that means a single 50bp jump or two 25bp increments.

The final paragraph did go on to emphasise the RBNZ's discomfort with the exchange rate, which has spiked on a trade-weighted basis in a way that seems inconsistent with the fundamentals. But they stopped short of saying that the high exchange rate could prevent the 50bp of near-term hikes. Instead, a persistently high exchange rate was seen as reducing the need for further OCR hikes, beyond the initial 50bp.

The RBNZ's current plan is clear, but it is conditional. Specifically, for the OCR to reach 3% by October the RBNZ must be satisfied that the domestic economy is continuing to recover. We think that is quite likely. The second condition is that global financial risks must recede, which is less than certain.

The US sovereign debt issue mainly comes down to a political impasse, and it's next to inconceivable that the impasse will remain unresolved by September. But ratings agencies might remain sceptical about the US's medium-term fiscal sustainability. Likewise, a myriad of open questions remains regarding the willingness and ability of Eurozone politicians to provide aid to troubled member economies outside Greece (and of those economies to work towards debt sustainability). Until far more progress is made on those questions markets will remain jittery.

Market implications and reaction

Markets were confused at first, but eventually interpreted the statement as hawkish and moved to price in at least a 25bp hike in September, with 50% chance of a 50bp hike. The NZD rose 20 points, and the 2-year swap rate rose 2 basis points.

RBNZ media release

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.

Reserve Bank Governor Alan Bollard said: "The economy has grown more strongly than was expected, and it appears that the

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recovery is getting back on track, supported by a strong terms of trade. At the same time, however, current fragility in global financial markets, including the uncertainty around the US Government's debt ceiling, continues to highlight the downside risk to trading partner activity noted in the June Statement.

"Annual headline CPI inflation continues to be above the Bank's 1 to 3 percent target band. However, much of the current spike in inflation has been driven by the October 2010 increase in the rate of GST, and will therefore be temporary. Wage and price setters should focus on underlying inflation, which is currently estimated to be below 2.5 percent.

"Provided current global financial risks recede and the economy continues to recover, the Bank sees little need for the March 2011 'insurance' cut to remain in place much longer. The current very high value of the New Zealand dollar is acting as a drag on the New Zealand economy. If this persists, it is likely to reduce the need for further OCR increases in the short term."

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