Westpac Institutional Bank

The more things change...

Oct 27 OCR review: RBNZ on hold at 2.5%

- **The Reserve Bank left the cash rate unchanged at 2.50% and again signalled a gradual rise in interest rates from next year.**
- **While the statement acknowledged that current economic conditions have softened, there was no overt change in the RBNZ's outlook for interest rates.**
- **We continue to expect the next OCR move to be a 25bp hike in June.**

Summary

Today's OCR review gave no indication that the Reserve Bank has changed its plans for interest rates since the September Monetary Policy Statement, which indicated hikes from around March next year. This was a mild surprise to markets, as some weaker economic developments here and offshore – particularly the soft inflation and business confidence figures earlier this week – might have given the RBNZ an opportunity to signal a delay to tightening. We are relatively more downbeat on global conditions than the RBNZ, so our call remains for the next move in the OCR to be a 25bp hike in June.

Details

The RBNZ's media release retained much of the language of the September statement, with a few necessary nods to developments since then. The overarching plan is still for a gradual increase in interest rates over the next couple of years, as activity picks up and the rebuild of Christchurch starts to put pressure on the nation's resources.

There were three acknowledgements of weaker domestic data. The first was that activity was described as growing at "only a modest pace", rather than "surprising on the upside". The 0.1% rise in June quarter GDP was disappointing after the solid gains seen in the two previous quarters. Secondly, the RBNZ noted that business confidence has fallen back in the last few months, which may be a warning that the recent turmoil in overseas markets is having some real effects here.

The third point was that underlying inflation was described as settling, rather than rising, around the midpoint of the 1-3% target range. The surprisingly low CPI result earlier this week meant that the RBNZ's preferred measure of 'core' inflation fell from 2.3% to 2.2% in the year to September.

On the more positive side, repairs and rebuilding in Christchurch are expected to provide "significant" impetus to demand, a subtle upgrade on the September statement. Official estimates of the cost of rebuilding have converged at around $20bn in recent weeks, from $15bn previously. This implies an even larger and longer boost to activity once it gets under way, and with most of it being funded by overseas insurers, this is something that's not subject to the broader economic cycle.

There was also a notable omission from this statement, with no reference to the high New Zealand dollar having a dampening effect on the tradable sector and inflation. The currency has been volatile in recent weeks but it has averaged about 3% below what the RBNZ assumed in September.

The RBNZ's stance on global conditions was largely unchanged from the September statement, which was already alert to the risks of a sharper slowdown in world growth and ongoing tightness in international funding markets. Funding conditions have actually improved a little relative to September – while the European sovereign debt crisis has arguably gotten even uglier, investors are growing more confident of a forceful policy response.

The final paragraph of the statement, which generally gives an indication for the near-term direction of monetary policy, read:

"Given the ongoing global economic and financial risks, it remains prudent to continue to keep the OCR on hold at 2.5 percent for now. However, if global developments have only a mild impact on the New Zealand economy, it is likely that gradually increasing pressure on domestic resources will require future OCR increases."

For further information, questions or comments contact Dominick Stephens, telephone (09) 336 5671, email dominick_stephens@westpac.co.nz

This is almost the same as in the September release, with the two sentences switched around. You could debate whether this reordering was meant to convey something about their relative importance; the key point is that the wording was largely unchanged, when the RBNZ could have said something more explicit about a slower pace of tightening.

Market implications

The NZ dollar immediately jumped 60pts and swap rates rose four basis points across the curve, a reaction in line with our impression that the statement was on the hawkish side of the range of possibilities. Interest rate markets are not fully pricing in an OCR hike until September next year, compared to the RBNZ's projections for around March. We expect these two views to eventually meet in the middle.

RBNZ media release

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

Reserve Bank Governor Alan Bollard said: "Domestic activity has continued to expand at only a modest pace despite relatively strong commodity prices. More recently, domestic business confidence has fallen back somewhat. Further ahead, earthquake repairs and reconstruction in Canterbury are still expected to provide significant impetus for demand.

"As foreshadowed at the time of the September Monetary Policy Statement, there is a real risk that the European sovereign debt crisis could cause a further slowing in global activity, putting downward pressure on New Zealand's commodity export prices. The difficult international market conditions could also result in increased New Zealand bank funding costs over the coming year.

"Annual headline CPI inflation continues to be above the Bank's 1 to 3 percent target band. That largely reflects the one-off effect of last year's increase in the rate of GST. September quarter inflation data suggest that, once GST and other one-off influences have passed, underlying inflation is settling near 2 percent.

"Given the ongoing global economic and financial risks, it remains prudent to continue to keep the OCR on hold at 2.5 percent for now. However, if global developments have only a mild impact on the New Zealand economy, it is likely that gradually increasing pressure on domestic resources will require future OCR increases."

Dominick Stephens, Chief Economist, Ph: (64-9) 336 5671

Michael Gordon, Senior Economist, Ph: (64-9) 336 5670