9 June 2011

Westpac Institutional Bank

Inching closer

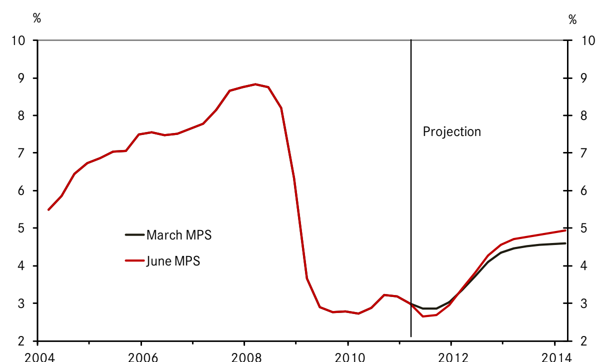
June MPS Review: OCR on hold, hike before year-end looking more likely

- **The Reserve Bank has grown more confident about the domestic recovery, and is setting the stage for a rapid policy tightening as post-quake reconstruction begins next year.**
- **The RBNZ was also surprisingly positive on the outlook for global activity, and expects the terms of trade and exchange rate to be stronger for longer.**
- **Like the RBNZ, we now see the next OCR move as likely to be a 25bp hike in December. An earlier move would face high hurdles, while a deterioration in world growth could see hikes delayed to next year again.**

There was a markedly more upbeat tone to today's Monetary Policy Statement compared to the last few OCR reviews, and with good reason: the domestic economy is gathering momentum again, and has held up far better than might have been feared following the Christchurch earthquake. But there were also some surprisingly strong judgements around global growth and New Zealand's export prospects.

The overall message was that monetary policy is no longer seen as closely tied to the reconstruction process, and the timing of rate moves will be more data-dependent. The Reserve Bank indicated that the next OCR hike is most likely to be a 25bp move in December, and we are taking it at its word. That said, we suspect that financial markets have overdone the pricing for early hikes. An October hike would face high hurdles, and would be ruled out if recent signs of a soft patch in global growth persist.

90 Day bank bill rate



As expected, the RBNZ noted that business confidence and consumer spending have recovered since the February earthquake, and that general signs of domestic economic recovery have continued. Reconstruction is expected to get under way in early 2012 with a very fast ramp-up that will quickly soak up the economy's spare capacity. While the RBNZ continued to talk about modest growth in consumer spending, there was a substantial increase in its forecasts compared to past statements – albeit from levels that we long regarded as unreasonably low.

What was more surprising were the RBNZ's changes of judgement around global growth, the terms of trade, and the exchange rate. In the past, the RBNZ has been sceptical of global growth prospects, concerned that New Zealand's terms of trade would fall, and therefore uncomfortable with the high exchange rate. This has changed significantly. The forecasts were fairly constructive on global growth, with only a brief nod to possible fragilities in the global recovery. Importantly, the RBNZ is expressing much greater faith in the longevity of New Zealand's terms of trade boom. Ironically, this more upbeat view comes when the outlook for global growth is more clouded than it has been for some time.

Naturally, if one is more comfortable with New Zealand's strong external position, one becomes more comfortable with a higher exchange rate. The trade-weighted index is now forecast to remain above 65 in coming years, helping to keep inflation low. Notably, the RBNZ described the high exchange rate as a negative factor for non-commodity exporters – the condition known as Dutch disease – but not as a drag on overall activity, as it did in the April statement. And as RBNZ officials noted, its mandate is around inflation, not the balance of activity.

The Budget didn't feature heavily in the statement (and curiously, the RBNZ's forecasts for government consumption were quite a bit higher than Treasury's). Reductions in public sector job growth and eligibility for welfare payments were seen

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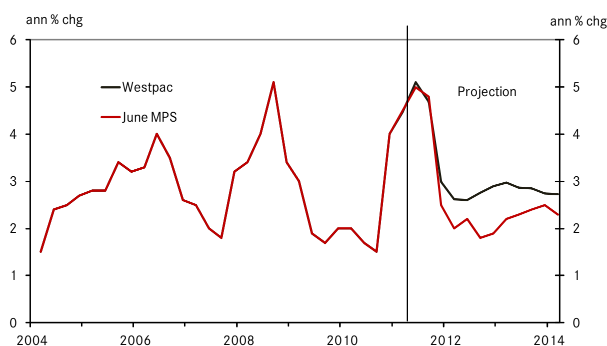
as negatives for household spending growth, but these effects seem to have been swamped by the broader upgrade to the consumption forecasts.

The MPS was hawkish in just about every aspect but one: inflation forecasts were still well within the target range, and no higher than they were in March. Part of that is due to a higher level and a slower rate of decline in the exchange rate projections; part of it is a more aggressive policy tightening to get on top of the problem early.

Consumer price inflation



But the subdued inflation forecast is also partly the consequence of a few key assumptions – that construction costs will remain relatively contained in the face of the reconstruction boom, that New Zealanders will continue to focus on paying off debt, and that increases in inflation expectations will be short-lived once the GST increase and fuel price rises wash out. There are clear upside risks around all of these assumptions, and particularly around inflation expectations – the RBNZ's central assumption has been that they will edge towards the middle of the target range, so the fact that they have been around the high 2's for some time will be troubling.

Market implications

The central bank's change in stance was reflected in its formal forecast for future interest rates. The 90-day rate is now forecast to rise from around 2.6% today to 3.0% by the end of this year – consistent with an OCR hike in December. The forecast then rises to 4.6% by the end of 2012 and 4.9% by the end of 2013 – a profile about 30 basis points higher than in March.

We are taking the RBNZ at its word regarding the start date for hikes, and we concur that a steep series of hikes is needed in 2012. Where we differ is the outlook for rates in 2013 and beyond. We are concerned that a growth spurt over the next few years, fuelled by reconstruction activity, high commodity prices, and the low starting point for interest rates, could provoke more inflationary pressure than the RBNZ is allowing for. Under these circumstances, we are very sceptical that the 90-day rate would peak as low as 5%. By 2013 the RBNZ expects the economy to be running more than 1% above its potential, a situation that typically requires monetary settings to be in outright 'tight' territory.

The implication is that the two- to four-year part of the yield curve may be too low at present. Borrowers should now consider fixing their interest rates, while savers may be better off on variable rates.

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 outlook for the New Zealand economy has improved since the publication of the March Statement.

"Economic activity has been significantly disrupted by the Christchurch earthquake. However, while many firms and households – particularly within Canterbury – continue to be adversely affected, it appears the negative confidence effect of the earthquake on economic activity throughout the rest of the country has been limited.

"The early signs of recovery noted in the March Statement have continued. Despite some continuing signs of weakness in the world economy, commodity prices remain very strong and firms expect to increase their hiring and capital investment. Reconstruction in Canterbury is projected to add about 2 percentage points to GDP growth over 2012, and boost the level of activity for several years thereafter.

"Despite the strong outlook for export earnings, household expenditure is expected to grow only modestly. Household debt remains very high and is expected to constrain retail spending and the housing market for some time. Continued fiscal consolidation will also act to dampen activity.

"The New Zealand dollar has appreciated substantially over the past two months. This appreciation, supported by high export prices for primary producers, is negatively affecting other parts of the tradable sector, constraining rebalancing of the New Zealand economy.

"Headline inflation is currently being boosted by recent increases in indirect taxes, food and petrol prices, and surveyed expectations of future inflation have edged up. Despite this, indicators of capacity usage and core inflation suggest underlying inflation remains constrained.

"As GDP growth picks up, underlying inflation is expected to rise. A gradual increase in the OCR over the next two years will be required to offset this, such that CPI inflation tracks close to the midpoint of the target band over the latter part of the projection. The pace and timing of increases will be guided by the speed of recovery, but for now the OCR remains on hold."

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