Westpac Institutional Bank

Not off the hook

September MPS Preview: OCR on hold at 2.50%

- **We expect that the Reserve Bank will leave the OCR unchanged at next Thursday's review, but will continue to signal the resumption of rate hikes in the near future.**
- **The recent tensions in global financial markets, with the tail risk of a messier collapse, argue for caution in the near term.**
- **But the domestic economy is gathering speed, and some of the RBNZ's crucial assumptions about inflation remaining in check are being tested.**
- **We expect the next move to be a 25bp hike in December.**

Summary

The Reserve Bank's last policy statement in July made its immediate intentions clear: "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." While the statement noted the growing downside risks to the global economy and the drag on growth from the persistently high NZ dollar, these were seen more as factors that would affect the path of monetary policy once the 'insurance' cut had been dealt with.

Since then the near-term global outlook has taken a nasty turn, as fears of sovereign debt default have spilled over into a broader range of markets. Even if authorities are able to contain the damage through decisive action, it will be some time before global financial risks could be said to have 'receded'. Our view is that the RBNZ will hold off on rate hikes until December (as we detailed in our Bulletin "Receding chance of early rate hikes", 10 August).

However, unlike July's terse media release, next Thursday's Monetary Policy Statement will have to expand on the medium-term outlook for inflation, which is increasingly worrying. The economy is recovering faster than realised, perceptions of inflation are not at all well-behaved, and some of the RBNZ's crucial inflation-dampening assumptions are looking shaky.

Details

Compared to the June MPS projections, domestic activity has been stronger than expected. GDP grew by 0.8% in the March quarter, despite the blow to activity in the Canterbury region after the 22 February earthquake, and December quarter growth was revised up from 0.2% to 0.5%. So far, the sectoral indicators for June quarter GDP are shaping up stronger than the RBNZ's 0.4% estimate. These add up to a substantially quicker reduction of the New Zealand economy's spare capacity than the RBNZ was anticipating.

Recent developments in Christchurch's recovery have ambiguous implications for the RBNZ's growth forecasts. On the one hand, issues such as access to insurance are threatening to slow the pace of rebuilding; on the other, the sharp increase in EQC's estimate of the extent of quake damage implies an even larger than expected boost to activity once the rebuild does get under way. The RBNZ has taken the view that the speed of the upswing in building activity, rather than the size of the total job, is what matters most for inflationary pressures.

There are already signs of wage and price pressures in the construction industry. Prices for heavy and civil engineering construction – where much of the rebuilding activity to date is likely to have been – rose more than 5% in the first half of this year. There are also signs of price pressures stirring in housing construction, even at the currently depressed levels of activity. This threatens one of the three crucial assumptions that the RBNZ made in June: that the localised nature and centralised management of the rebuilding job would reduce the inflationary effects relative to past construction booms.

Another of the RBNZ's assumptions – that recent increases in inflation expectations reflect a temporary spike in headline inflation, and will be short-lived – is also looking shaky. The July OCR statement appealed to wage and price setters to "focus on underlying inflation, which is currently estimated to be below 2.5 percent". But that estimate doesn't seem to resonate with people. Expectations for inflation a year from now are well above 3% – by which time most of the policy distortions such as the GST increase will have dropped out – and only slightly below 3% for two years ahead. We suspect that inflation expectations are increasingly being driven by a recognition of that earlier factor: the price pressures that will be generated by the rebuild of Christchurch.

The third assumption – that households will continue to focus on reducing debt – looks reasonably sound for now. It's true that

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retail spending has picked up since the start of the year, but with incomes starting to grow again, it is possible to spend more and reduce debt at the same time.

While domestic conditions are pointing towards tighter policy, the renewed turmoil in overseas markets argues for caution. There are growing concerns around the stalling of growth in the US and Europe, the health of European banks, and what governments and central banks will (or can) do in response. At the least, the RBNZ will take a decent whack off its forecasts for growth in our major trading partners, which in turn will mean a softer outlook for export growth.

It's worth noting that to date there has been remarkably little sign of these global tensions being transmitted through to the New Zealand economy. Business confidence held up fairly well when the turmoil began in August, and actually picked up again in early September. Local share prices are down less than 4% since late July, whereas global shares have tumbled by 13%. World dairy prices have fallen in recent months (something that Fonterra says it anticipated in its forecast payout for this season) but commodities more generally have held up – not something you would associate with a global economy supposedly heading into recession.

One channel that the RBNZ will be particularly wary of, given the experience of the 2007-08 financial crisis, is a rise in the cost of funds in international markets, which could push up lending rates in New Zealand independently of any moves in the OCR. To date this hasn't been apparent, because swap rates – the benchmark for funding costs – have themselves fallen sharply. But if the tensions in global money markets persist, the RBNZ will be eyeing a lower peak for the cash rate.

Overseas developments present a 'tail risk' to the outlook for New Zealand – there is some chance of another messy collapse like in 2008 – but they don't remove the need for the RBNZ to return policy settings to more neutral levels. New Zealand's inflation problems are largely home-grown; the fact is that at some point the RBNZ is going to have to hike into a still-soft global environment.

Statement and market implications

We expect next week's MPS to reflect the growing tensions between domestic inflation pressures and the uncertain global picture, with the balance of the two leaving a similar outlook to the June statement. Growth forecasts will be revised up for this year (they were already pretty strong for next year, when the rebuild is expected to ramp up), and inflation is likely to remain consistently in the top half of the 1-3% target range. However, we expect a similar track for 90-day rates over the next year or so, consistent with a December start to hikes and around 150 basis points of tightening next year.

There are two factors that may warrant extra attention. The first is the New Zealand dollar, which on a trade-weighted basis is around 5% higher than was assumed in June. The RBNZ has already noted that this will act as a drag on the economy, though at the time it wasn't regarded as a barrier to removing the 'insurance' rate cut.

The second factor is the persistent strength of inflation expectations. Headline inflation will start to ease from Q4 this year, as factors such as the GST increase drop out of the equation. The RBNZ may warn that if inflation expectations fail to moderate in line with this, then interest rates will need to rise even further than in its central projection.

The key 'bias' paragraph of the statement should convey the point that a substantial tightening cycle is on the way, while acknowledging the near-term uncertainty around global conditions. We expect language along the lines of:

"In light of the ongoing financial fragility and heightened risks to global growth, the OCR remains on hold for now. However, as the economy continues to recover, underlying inflation is expected to rise. A gradual increase in the OCR over the next two years will be needed to offset this, such that CPI inflation remains within the Bank's 1 to 3 percent target band in the latter part of the projection."

Interest rate markets are pricing a 20% chance of a rate hike next week. We think that's actually a fair assessment – if the RBNZ has come to see the first 50bp of hikes as somehow different from the rest of the cycle, as the July statement implies, then it could still decide to push them through regardless of what's happening elsewhere.

But beyond that date, markets are factoring in much less in the way of tightening than we or the RBNZ expect. The first OCR hike not fully priced in until next March, and less than 100bp of hikes over the next two years. There is scope for market interest rates to rise after next week's review, depending on how strongly the RBNZ words its statement, and how far markets can take their eyes away from overseas developments.

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