Westpac

Institutional Bank

All eyes to Europe

September MPS Review: RBNZ on hold, signals later start to hikes

- **The RBNZ signalled a delayed start date for OCR hikes, as expected.**
- **Domestic conditions still warrant higher interest rates.**
- **But global uncertainties will stay the RBNZ's hand until next year.**
- **We now expect the first OCR hike will be +25bp in January, depending on how the European sovereign debt crisis pans out.**

Summary

Messy conditions in global financial markets were the dominant concern of today's *Monetary Policy Statement*. The Reserve Bank reiterated that domestic economic conditions and emerging inflation pressures warrant higher interest rates. However, the deteriorating global economic and financial market situation calls for a later start and possibly a lower peak to the OCR cycle. We now expect the next move to be a 25bp hike in January (previously +25bp in December).

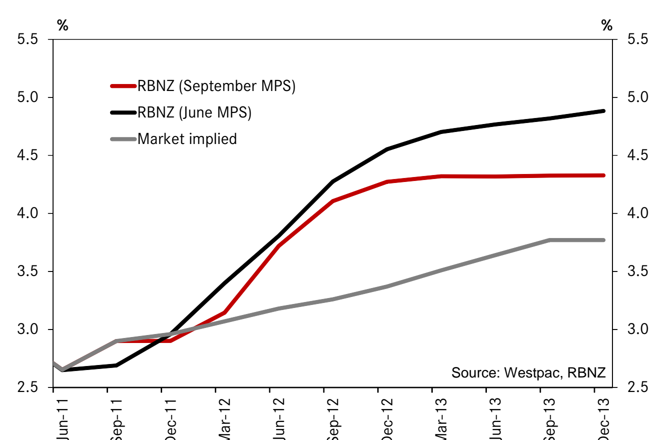
Details

As expected, the RBNZ softened its stance relative to the July OCR review, which had warned of an imminent reversal of the 50 basis point cut in March – provided that global financial risks receded. Instead, those risks have intensified since July. For New Zealand, the most important implication has been a sharp rise in the credit default swap (CDS) spreads for Australasian banks – meaning that New Zealand banks would now have to pay higher premiums if they borrowed from overseas.

The crucial issue is how long CDS spreads remain elevated. As it stands, New Zealand's main banks are in a better funding position than during the Global Financial Crisis (GFC) in 2008/09, and are not under pressure to actually borrow from overseas at the moment. But the longer CDS spreads remain high, the more likely it is that banks will actually have to pay the higher cost of funds, at which point interest rates would rise independently of the OCR. If this did come to pass, the RBNZ would respond with fewer OCR hikes. Essentially, rising funding costs might end up doing some of the inflation-control work normally reserved for the OCR.

The RBNZ's 90-day rate projections now imply a delay in rate hikes until the March quarter of next year, and a peak of 4.3% by the end of next year (roughly equivalent to a 4% cash rate). That's substantially lower than the projections in June, but is still a higher peak (and a much faster rise) than what markets are currently factoring in *(Figure 1)*. It may be that markets are factoring in a chance of a messy outcome to the European sovereign debt crisis.

Figure 1: 90-day rate forecasts: RBNZ Sep vs June, market implied



In terms of its read on the broader economy, the RBNZ still expects the domestic recovery to continue, anticipates a sizeable (but more drawn-out) reconstruction boom in Christchurch, and notes that the global economy is slowing but expects only a modest impact on New Zealand exporting conditions. GDP is expected to grow by 2.8% in the year to March 2012 (compared to 2.5% in the June statement), but to peak at just 3.1% in the following year.

Compared to the June MPS, the RBNZ has moderated its expectations for the pace of reconstruction in Christchurch *(Figure 2)*. The Reserve Bank has joined the consensus by forecasting "only" 38% growth in construction activity for the year to March 2013. Major repairs are still expected to get under way by early next year, but barriers such as lack of access to insurance mean that full rebuilds are not expected to begin in earnest until mid-2012. On top of this, it appears that the RBNZ has assumed a much slower ramp-up in rebuilding once it does began – and it argues that it is the pace of rebuilding, not the total size of the job (now assumed to be $20bn, from $15bn initially), that matters most for inflation and interest rates.

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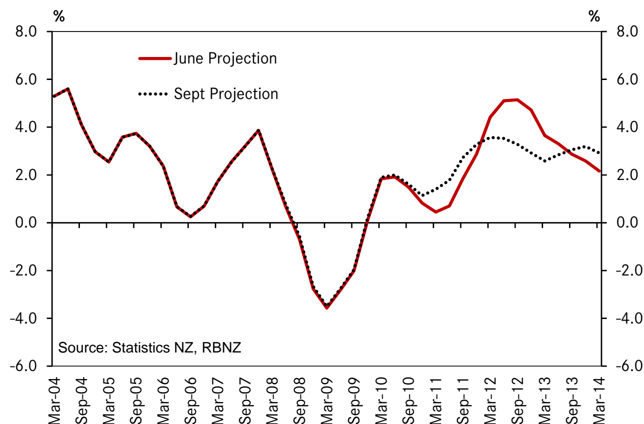
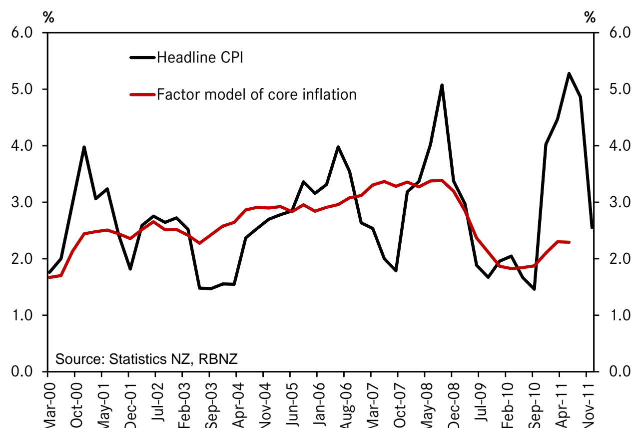
Figure 2: RBNZ GDP growth forecasts, Sep vs June



The RBNZ expects annual inflation to be steady around 2% once last year's GST increase and other government charges have dropped out of the equation. This is a slightly lower track than in June, partly due to the slower assumed pace of reconstruction and partly due to the sustained strength of the NZ dollar. However, the RBNZ remains alert to the challenge of keeping inflation expectations in check, repeating that underlying inflation is currently estimated at 2.3% (albeit rising).

Figure 3: OCR Inflation forecasts



We still think the RBNZ is a little sanguine on inflation. The Bank appears to have stuck by its triumvirate of inflation-reducing assumptions: Christchurch reconstruction will put less pressure on construction costs than previous nationwide housing booms, inflation expectations will fall once last October's GST hike drops out of the headline inflation figures, and consumers will continue to save rather than spend. To our mind, the first two of these assumptions have already been tested and found wanting by data to hand. We suspect that the coming OCR cycle will extend further than the Reserve Bank is currently signalling.

Market implications

The bottom line is that domestic conditions already warrant higher interest rates, and at some point the RBNZ is going to have to hike into a less-than-ideal global environment. However, that environment has become much more perilous in the last few months, and the complex interaction of financial markets and policymakers makes it impossible to anticipate just how this will be resolved.

For now, we believe the most likely start date for OCR hikes is January next year (the RBNZ's projections suggest March, but we believe emerging inflation pressure argues for a slightly earlier move). But like markets, we will take our lead on New Zealand monetary policy from developments in Europe over the coming months, and will adjust the short-term outlook accordingly.

Markets barely responded to the central bank's missive. Two-year swap rates fell around 2 basis points, while the NZD fell to a low of 81.77 from 82.55 before. We regard today's swap rates as too low. New Zealand's interest rates will have to rise at some point – the mammoth reconstruction task in Christchurch will make sure of it.

RBNZ media release

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

The New Zealand economy has performed relatively well while headline inflation has increased somewhat since the June *Statement*. At the same time, however, global economic and financial risks have increased.

Domestic economic activity has surprised on the upside and capacity usage appears to have increased. Continued high export commodity prices and, in time, reconstruction in Canterbury are expected to provide impetus to demand over the projection horizon.

However, the outlook for New Zealand's trading partners has deteriorated markedly. There is now a real risk that global economic activity slows sharply.

Global financial market sentiment has also deteriorated. Sovereign debt concerns in Europe and the weakened global outlook have caused international bank funding markets to tighten. If conditions do not improve, New Zealand bank funding costs will increase.

Largely because the New Zealand economy has been doing better than many others, the New Zealand dollar has appreciated since the June *Statement*. The high level of the New Zealand dollar is having a dampening influence on some parts of the tradable sector and on imported inflation.

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 last year's increase in the rate of GST, and will therefore be temporary. Wage and price setters should focus on underlying inflation, which, while rising, is currently estimated to be near 2 percent.

If recent global developments have only a mild impact on the New Zealand economy, it is likely that the OCR will need to increase. For now, given the recent intensification in global economic and financial risks, it is prudent to continue to hold the OCR at 2.5 percent.

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