8 December 2011

Westpac Institutional Bank

Another world

December *MPS* Review: OCR on hold at 2.50%, RBNZ softens stance, but next move is still up

- **The RBNZ has softened the outlook for monetary policy, and is now signalling gentle hikes from June 2012.**
- **Domestic economy still seen as warranting hikes…**
- **…but global risks dictate a prudent stance "for now".**
- **The RBNZ poured cold water on notion that the next move might be a lower OCR.**
- **We continue to forecast an extended OCR hiking cycle beginning in September 2012.**

Summary

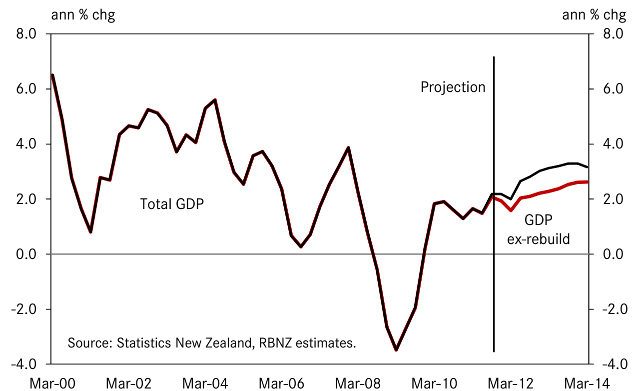
The tone of today's *Monetary Policy Statement* was broadly in line with what we expected, with a weaker global outlook translating into a softer profile for interest rate hikes in New Zealand. There were a couple of points worth emphasising: first, the Reserve Bank is still actively looking to head off the inflation pressures that are likely to be generated by reconstruction in Christchurch. And second, in contrast to recent market pricing, the RBNZ is not entertaining the idea of rate cuts at this stage. We continue to expect gradual increases in the OCR from September next year – a later start than what the RBNZ indicated, reflecting our weaker outlook for global growth.

Details

The Reserve Bank acknowledged that risks to the global economy identified in previous statements are increasingly becoming reality. New Zealand's major trading partners are now expected to grow by 3.4% next year, with Europe slipping back into recession and Asia ex-Japan growing at a significantly slower pace. While the negative impact on New Zealand has been limited to date, it undoubtedly played a part in the significant downgrades to the RBNZ's near-term forecasts for growth in consumption, business investment and exports.

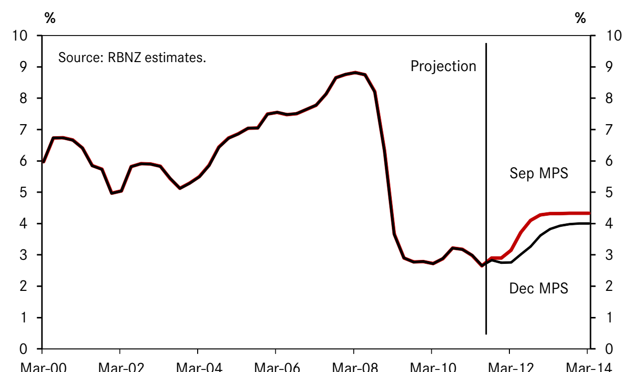
Not all of the downgrade to the growth outlook can be pinned on global events. The starting point for the domestic economy appears to be weaker than the RBNZ assumed in September; in particular, residential construction (outside of Christchurch) has responded more slowly than expected to the developing squeeze in housing supply. GDP growth in the year to December 2011 was pegged at 2.2%, compared to 3.3% in the September *Statement*. But the GDP forecasts for 2012 and 2013 were stronger, at 3.0% and 3.3%. The outlook for earthquake-related activity was broadly unchanged, adding around 1% to GDP growth for each of the next two years. (Note that by September the RBNZ had already concluded that rebuilding wouldn't begin in earnest until the second half of next year, in line with The Treasury's view.)

Figure 1: RBNZ GDP growth forecasts



Growing global risks and the weaker current domestic position meant the RBNZ chose to signal a later and flatter profile for OCR hikes, compared to the September projections. The ongoing tensions in international credit markets were also factored in, with the RBNZ noting that funding costs for New Zealand banks "will increase" (as opposed to "could") over the coming year. The RBNZ's implicit long-term assumption is that retail interest rates will rise by about 30bp independent of the OCR. This is fully offset by a lower assumed peak in the OCR forecast.

Figure 2: RBNZ 90 day interest rate forecasts



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However, even with the significant downgrades to its projections, the RBNZ remains much more hawkish than financial markets. The statement emphasised that higher interest rates are still necessary because "over time, repairs and reconstruction in Canterbury will provide a significant boost to demand for an extended period". The interest rate projections are consistent with rate hikes beginning in mid-2012 – given that rebuilding in Christchurch is not expected to begin "in earnest" until the second half of the year, this would be a very proactive stance.

As for the market's recent shift towards pricing some chance of rate cuts next year, the RBNZ didn't even entertain the possibility. In fact, the MPS set out an alternative scenario to demonstrate what it would take to cancel interest rate hikes for the foreseeable future – never mind rate cuts. It turns out to be quite a lot: the scenario includes a global downturn almost as deep and longer-lived than in 2008/09, leading to a downturn in New Zealand. The situation would have to be even worse before the RBNZ contemplated cutting the OCR.

To be fair, we should note the scope of this alternate scenario: a much deeper downturn in activity in Europe, with knock-on effects to the rest of the world, but with credit markets continuing to function (though funding would remain expensive to due global risk aversion). A full-blown financial crisis would probably be another story – one that doesn't really lend itself to economic modelling, but would involve OCR cuts.

Market implications

Market reaction to the relatively hawkish MPS was virtually nil. Market pricing for possible OCR cuts reflects a tail-risk of a dire outcome in Europe. So until the European situation is resolved one way or another, the gap between market pricing and RBNZ projections is likely to remain.

Our own view is that the next move will be a 25bp hike in September. We are just a bit more pessimistic about the prospects for Asian and European economic growth than the central bank, but the difference of opinion is minor.

Where our view does differ is that we think the peak in the tightening cycle will need to be much higher than 4%. We've alluded to this view many times before. To recap our argument, we don't believe that higher bank funding costs can forever be offset with a lower OCR. The 'new normal' in global credit markets means that the world is less willing to lend to New Zealand at any given interest rate. With less funding coming from overseas, more of the gap would need to be made up from local sources – and that would require higher domestic interest rates to balance savings and loans. To say that this can be completely offset through a lower OCR is effectively saying that we can dictate to international lenders what return they will receive. There are many parts of Europe that are currently demonstrating otherwise.

Media release

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

Reserve Bank Governor Alan Bollard said: "As foreshadowed in the September *Statement*, global conditions have deteriorated. Continuing difficulties related to sovereign and bank debt in a growing number of European economies have resulted in high levels of volatility in financial markets. There has also been a softening in international economic activity, including in the Asia-Pacific region.

"Global developments are having some negative impact on New Zealand, though to date it has been limited. Business confidence has declined and investment spending is likely to remain weak for some time. In addition, tightness in international markets means funding costs for New Zealand banks will increase to some degree over the coming year.

"There remains a high degree of uncertainty around the global outlook and, as discussed in the scenario in this Statement, there is a risk that conditions weaken further.

"Domestically, economic activity continues to expand, though at a modest pace. Although off their peaks, export commodity prices remain elevated. In addition, the depreciation of the New Zealand dollar provides some support for the tradable sector of the economy. Over time, repairs and reconstruction in Canterbury will also provide a significant boost to demand for an extended period.

"Annual headline inflation is estimated to have returned within the Bank's 1 to 3 percent target band in the December quarter. Underlying inflation continues to sit close to 2 percent. In addition, wage and price setting pressures have remained contained.

"Given the current unusual degree of uncertainty around global conditions and the moderate pace of domestic demand, it remains prudent for now to keep the OCR on hold at 2.5 percent."

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