Westpac Institutional Bank

Hold fire

December MPS Preview: OCR on hold at 2.50%, rate hikes further delayed

- **We expect next week's Monetary Policy Statement will emphasise that global risks will keep the OCR on hold for an extended period, in a significant change of stance.**
- **Domestic conditions have not changed significantly since the RBNZ's last prognostication. The intensifying financial risks in Europe are a threat to New Zealand.**
- **Gradual rate increases are still on the cards as rebuilding in Christchurch picks up, but not before Europe's debt crisis is adequately resolved.**

Overseas concerns will be at the fore of Thursday's Monetary Policy Statement (MPS), prompting the Reserve Bank to signal a significant change in stance. The September MPS signalled steep hikes beginning in March 2011. This time, the RBNZ is likely to push the mooted start date out to late 2012, and to signal a less aggressive program of hikes. However, we don't expect the central bank to adopt the position taken by markets, where OCR cuts are seen as more likely. The longer-term plan will still be for higher interest rates as growth picks up and rebuilding in Christchurch puts a squeeze on the nation's resources.

Details

Domestic developments since the October OCR review won't have given the RBNZ reason to jump one way or another. Most of the recent data has related to the September-October period, when the Rugby World Cup appeared to be helping activity in some areas and hindering it in others, with the net impact unclear. September quarter retail sales were much stronger than early indicators such as electronic card transactions had suggested, but they were really only in line with pre-tournament expectations.

The real concerns are around the global economy, and in particular the escalating fears of a euro zone breakup, with a resulting wave of sovereign and bank defaults across the continent. While the situation is very fluid (and developments in the last week have been much more positive), it's becoming clear that even the best case scenario will be one of poor global growth. Europe is already heading into recession, Asian growth is slowing significantly, and the US is struggling to gain any real momentum.

In the last two OCR reviews the RBNZ has maintained a surprisingly constructive tone on overseas influences, even while acknowledging that "there is a real risk" that global activity slows sharply. But we think the RBNZ is set to significantly downgrade its world growth forecasts this time – the November Financial Stability Report, while not commenting directly on monetary policy, indicated as much – with the obvious implications for monetary policy.

The main channels of contagion from Europe to New Zealand – as both we and the RBNZ have been highlighting for many months – are likely to be through export prices and the cost of overseas funding. Commodity prices have actually held up fairly well to date, with a lower exchange rate also providing a buffer. That said, we are expecting further declines in both over coming months.

The more worrying channel is offshore funding costs, which have relative to the benchmark swap rates in response to the Eurozone crisis. At the very least, this argues for delaying a return to interest rate hikes until there is some clear resolution to the offshore situation – and no-one can confidently put a date on that.

On top of this, the RBNZ's assumptions about the long-term outlook for funding costs ties directly into when and where it sees the peak in the OCR cycle. In September the RBNZ assumed that funding costs would ease from their peaks in the near term, then settle at some high (but unspecified) level over the duration of its forecasts. Today's starting point is around 20 basis points higher than it was in September; some of this may be built into the RBNZ's long-run assumptions, implying a lower peak in the OCR as an offset.

Weaker world growth forecasts and tighter credit conditions could amount to a substantial change in the RBNZ's interest rate projections compared to the September MPS. An eventual return to a normal level of interest rates will still be on the cards, but at

For further information, questions or comments contact Dominick Stephens, Chief Economist, Ph: (64–9) 336 5671, email dominick_stephens@westpac.co.nz

a slower pace. We expect the peak in the 90-day rate projections to be shaved down from 4.3% to more like 4.1%, and the pace of tightening to be slowed relative to the September MPS (which indicated 140bps of hikes through next year).

Our previous pick was for tightening to resume in June next year. But even if the global situation starts to stabilise today, by mid-2012 the RBNZ is still likely to be facing soft world growth, inflation at a low ebb (we expect it to bottom out at 1.6%), and only a modest growth impulse as reconstruction in Christchurch gets under way. On that basis it's hard to see an interest rate track with OCR hikes starting earlier any than September next year, and maybe as late as December.

Statement and market implications

Next week's media release is likely to emphasise that monetary policy will remain on hold while global uncertainties are running high. World growth forecasts will be revised down, though probably not as far as our below-consensus view, and the risk that tensions in global credit markets could translate to higher bank funding costs will be reiterated.

Inflation will not be a pressing concern this time – annual inflation of 4.6% is still being influenced by last October's GST hike, and is expected to fall comfortably back within the 1-3% target range over the next year. While inflation expectations are still on the high side, the ability of firms to actually raise prices will be questioned.

The RBNZ will maintain the view that gradual increases in the OCR will be required in the future – the pressures on domestic resources from the Christchurch rebuild can't be ignored. That stands in contrast to recent market pricing, where an OCR cut is seen as the more likely next move – a 25bp cut by March was more than fully priced in a week ago, although this has since pulled back to a one-in-four chance.

Our take is that markets are not anticipating a single rate cut, but are factoring in the possibility of a catastrophic outcome in Europe, which could require large cuts in the OCR – even at 2.50%, the RBNZ would have room to manoeuvre in this situation. Of course, the market's gyrations in recent weeks show just how hard it is to pin down the odds of such an outcome.

The RBNZ probably won't feel the need to address market pricing directly. Instead, it may point out by keeping the cash rate at 2.50% it is providing substantial support to the economy. The last paragraph of the OCR review may run along the lines of:

"While gradually increasing pressure on domestic resources will eventually require OCR increases, it seems prudent to keep the OCR at its current stimulatory level until global economic and financial risks have subsided."

It's hard to predict how markets would respond to such a statement, as they are likely to remain fixated on overseas developments. The MPS comes a day before an EU summit where yet another "comprehensive solution" to the Eurozone crisis is expected to be hashed out; market expectations (and the risk of disappointment) are likely to be riding high around the time of the OCR review.

Dominick Stephens, Chief Economist, Ph: (64-9) 336 5671
Michael Gordon, Senior Economist, Ph: (64-9) 336 5670