10 August 2011

Westpac Institutional Bank

'Receding' chance of early rate hikes

RBNZ on hold until December

- **We now expect the Reserve Bank to leave the OCR on hold in September, with the next move being a 25bp hike in December.**
- **The RBNZ set out two conditions for removing the 'insurance' rate cut put in place after the February quake: that global financial risks recede and the economy continues to recover.**
- **One of those conditions is clearly not going to be met by September.**

Global financial conditions have taken a nasty turn recently, 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 swift action – and the bounce in equity markets this morning, following the US Federal Reserve's prognosis of low interest rates for longer, is an encouraging sign – we suspect the experience has been sufficiently bruising to influence the RBNZ's plans. **We now expect the RBNZ to delay tightening until December, with the March 'insurance' rate cut removed in two 25 basis point steps in December and January.**

In the 28 July OCR review, the RBNZ stated that: "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 many took this to mean that the 50bp insurance cut would be removed in one go at the next review in September, we weren't so sure. The domestic economy is clearly on the road to recovery, but for global financial risks to recede in such a short timeframe would have been a tall order. Our pick for the removal to be spread across two 25bp hikes in September and October was a nod to the uncertainty around global conditions.

We're now clearly past the point where financial risks could possibly be described as receding. The global economy is slowing – that in itself has not been a surprise to us, but it's likely to be several months before we have some indication of where the slowdown will bottom out. And even if the plunge in risky assets were halted today, the underlying cause of the turmoil – the intractable problems with sovereign debt burdens in many parts of the Northern Hemisphere – will remain in the background.

Consequently, it's clear that the RBNZ's condition of 'receding financial risks' will not be met by the 15 September *Monetary Policy Statement*, and probably not by the 27 October OCR review either. So we peg December as the most probable start date for rate hikes – and even that is subject to how global markets pan out in coming months.

Our change in call effectively takes us back to the profile laid out in our recent *Economic Overview* ("Against the tide", 26 July). We already felt that the uncertain global environment and the strong New Zealand dollar would see the RBNZ hold off tightening until December; we shifted our call to a September hike only because the RBNZ signalled this so strongly in the July OCR review.

Market implications

Our call for a 25bp hike in December is in line with market pricing at the time of writing – though that matter is hardly settled, with pricing having swung wildly over the last few days between a 50bp hike this September and a 25bp hike next June. Were the RBNZ to release a statement today, signalling a December hike, we don't' think that it would have a lingering impact on markets.

However, the real point of contention lies not in the near term, but in the extent of the tightening cycle over the next few years. The RBNZ's last projections suggested an OCR peak of around 4.5% by late 2013; our view has long been that the OCR is more likely to return to an about-average level of 6%. In contrast, the market is now pricing a peak of no more than 3.5%. Admittedly, though, the outlook for rates is unusually binary at the moment. If global conditions deteriorated into another full-blown financial crisis, then OCR *cuts* could be on the cards. But if the current turmoil is brought under control as hoped, then the RBNZ will revert to its plan to return the OCR towards a 'neutral' level.

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