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Westpac Institutional Bank

Treading carefully

June 14 OCR Preview: RBNZ on hold at 2.50%

- **We expect the RBNZ will hold the OCR at 2.5%, but emphasise its ability to reduce the OCR if global financial conditions worsen.**

The Governor of the Reserve Bank must have endured grim reading when he reviewed the economic situation ahead of next week's OCR decision and Monetary Policy Statement. The European sovereign debt crisis has ratcheted up to a new level of danger, and the outcome is wildly unpredictable. Economic data has soured across the globe, including China and Australia. The price of New Zealand's export commodities has fallen precipitously. The domestic economy is still operating below capacity and is recovering only slowly. And inflation is mostly harmless. The only real bright spot is the domestic housing market, but even in that area some recent data has ticked down.

This might, at first glance, seem like the sort of environment in which the Reserve Bank will reduce the OCR. We argue that it will not, for two very compelling reasons – monetary conditions have already eased, and the uncertain environment argues for maintaining flexibility.

Sharp declines in swap rates and the exchange rate over recent weeks have done much of the work for the Reserve Bank, and will cushion the economy. Falling swap rates have translated into lower fixed mortgage rates. Significantly, we have observed an increased tendency among borrowers to opt for fixed rates where they are lower than the floating rate. Even more significant for the Reserve Bank is the exchange rate, which has fallen almost 5% on a trade weighted basis since the April OCR review. Back then the Reserve Bank expressed deep concern that the exchange rate had held up even as New Zealand's export commodity prices fell. The recent depreciation will have assuaged those concerns, although the Reserve Bank will not be completely placated – the exchange rate is still high relative to New Zealand's deteriorating fundamentals.

One important consideration for the Governor is the effect an on-hold decision would have on monetary conditions. Given that markets are factoring in a small probability of a cut, an on-hold decision would probably cause interest rates and the exchange rate to rise. However, any such effect would be so small and fleeting that the Governor need not be concerned about undoing the recent easing in monetary conditions. Markets are distinctly focussed on international goings on. Any market reaction to an on-hold decision on the 14th June would pale in comparison to the gyrations that could occur after Greece's elections on the 17th.

The wild uncertainly of the international situation – and the fact that at least one defining event will occur shortly after next week's Monetary Policy Statement – incentivises the Reserve Bank to adopt a wait-and-see approach. The Greek election might set off a chain of events that leads to a GFC-style banking crisis in Europe. Failure to recapitalise Spain's third-largest bank might do the same. But the most likely scenario is that Europe engineers another muddle-through rescue plan which calms markets for a while at least.

The point is, the RBNZ will not know which scenario we are heading into when it issues its Monetary Policy Statement on the 14th. So the best strategic option at that point is to leave the OCR on hold. This is best illustrated by considering the "what ifs."

What if the euro zone becomes a disaster zone? The RBNZ would want to deliver confidence-boosting OCR cuts. But if it reduces the OCR next week, its latitude to deliver cuts in the worst case scenario would be curtailed. Better to wait.

What if Europe avoids meltdown? In that scenario, the RBNZ would be best-placed with an OCR of at least 2.5%. After all, confidence in the New Zealand economy is still reasonably strong. And the RBNZ is conscious of the risk that the resurgent housing market and post-earthquake construction activity could prompt inflationary pressure.

Hence we expect an on-hold OCR decision next week, and an accompanying statement that emphases the Reserve Bank's willingness and ability to cut the OCR if necessary. The final paragraph might include a phrase along the following lines:

"Should global financial and economic conditions deteriorate further, the Bank has latitude to reduce the OCR. For now, it is appropriate to keep the OCR at 2.5 percent."

The press release may repeat some of the key themes on the domestic economy that have appeared in every OCR review this year: inflation is low, the domestic economy is showing tentative signs of recovery, and the Canterbury rebuild will eventually add to inflation pressure. Commentary on global economic and financial conditions will be much more negative. We expect the Reserve Bank will make special mention of the sharp fall in global prices for New Zealand export commodities. On the exchange rate, we anticipate a disapproving comment along the lines of *"although the exchange rate has fallen, it remains high relative to fundamentals such as the terms of trade."*

Consistent with ambivalence about the next OCR move, the RBNZ's forecasts will probably predict no change in 90-day interest rates for the next year or so. For 2014, the Reserve Bank may forecast gently rising interest rates, if only to remind markets that the OCR is currently below its long-run sustainable level.

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