14 June 2012

Westpac Institutional Bank

Shadows on the wall

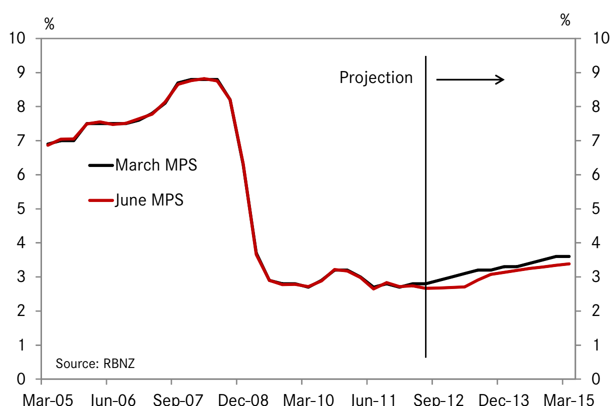
June *MPS* Review: OCR unchanged at 2.50%, RBNZ reiterates on-hold stance

- The OCR is on hold for 2012 unless Europe descends into outright catastrophe.
- The RBNZ gave a pointed reminder about burgeoning domestic inflation pressures.
- This backs our view that the OCR will be left unchanged this year. We continue to expect four hikes in 2013.

Today's *Monetary Policy Statement* was a little more upbeat than we and the market were expecting, with the RBNZ affirming its on-hold stance and making little concession to the possibility of interest rate cuts. While the RBNZ explored the risks stemming from the unfolding euro zone crisis, it was reluctant to draw conclusions. It devoted more attention to falling commodity prices, which could have a material impact on New Zealand's economy.

The uncertain global outlook was weighed against the lower exchange rate and lower fixed mortgage rates. The RBNZ also emphasised the strengthening domestic picture, and noted signs that the economy may be closer to its non-inflationary speed limit than once thought. Overall, the *Statement* backs our view that the OCR will be left unchanged this year. We expect four hikes in 2013.

Figure 1: RBNZ 90 day track, March vs December



The RBNZ judged that on balance the economic outlook has weakened "a little" since the March *MPS*, with a correspondingly small downgrade to its already-low interest rate projections. The 90-day rate is expected to hold at 2.7% through to the March quarter of next year, rising to 3.1% by September – that's consistent with an OCR hike somewhere in the middle of next year. As we expected, the end-point of the projections has been shaved down further, reaching 3.4% (albeit still gradually rising) by early 2015.

This stands in contrast to financial market pricing, which in recent weeks has been factoring in between one and two OCR cuts by September. The RBNZ's interpretation (which we share) is that market pricing reflects "a small chance of a hefty reduction in the OCR in the event of a major adverse global event". And even on that front, the RBNZ seems reluctant to give away much. The MPS discussed at length the risks stemming from the euro zone, but largely highlighted the potential channels of contagion to the New Zealand economy, rather than trying to develop an alternate scenario as it has done at times in the past.

The *MPS* did conclude that "one or more countries leaving the euro area, or a disorderly major default... would be expected to result in materially weaker monetary conditions in New Zealand" – allowing for some mix of a weaker exchange rate and official interest rate cuts. The overall impression is that the RBNZ is reluctant to be seen as pre-committing to any course of action, given the huge and immediate unknowns around the European situation.

One area where the RBNZ could speak with more confidence about the impact of the weaker global outlook was commodity prices. In fact, this is one of the most substantial changes relative to the March *MPS* forecasts – New Zealand's export prices in world terms are now projected to fall another 8% from here, compared to a fairly benign assumption in March. At least part of this is supply-driven and likely to be reversed – global milk production has risen sharply in the last year, itself a response to previous high world prices. But the change in view has had a substantial downward impact on the RBNZ's economic growth forecasts. The recent fall in the NZ dollar has softened some of the blow, although the RBNZ noted that the currency remains "elevated".

In contrast to the weak global outlook, the discussion of the domestic economy was relatively upbeat. The housing market continues to gather momentum, and repairs and rebuilding in Canterbury are on track to provide a substantial boost to construction activity in the next few years. Domestic activity is clearly responding to low interest rates, with the recent falls in fixed-term rates providing a fresh buffer against the global risks. There is little reason for the RBNZ to contemplate rate cuts in

the absence of a European blow-up.

One of the most notable aspects of today's *Statement* is that the RBNZ has had a major rethink about the New Zealand economy's potential rate of growth (often dubbed the "speed limit"). This matters immensely in the RBNZ's framework: when the economy is running above its potential, the strain on resources will put upward pressure on prices, requiring a monetary policy response. The RBNZ suggests that reduced capital investment and increased risk aversion in the wake of the global financial crisis may have reduced New Zealand's potential rate of growth over the next few years.

The trouble with potential GDP is that it can't be observed, only inferred from other indicators and with the benefit of hindsight. The RBNZ's previous assessment was that the weak pace of recovery in the last few years had left the economy with a substantial amount of spare capacity, which would put downward pressure on prices. Yet inflation, while admittedly low at the moment, has never threatened to drop below the lower end of the 1-3% target band (and most of the weakness has been in tradable goods, reflecting the strong NZ dollar rather than spare capacity in the local economy). The unemployment rate has remained stubbornly high, yet the reported difficulty of finding skilled workers is nudging back towards average levels. And wage inflation has risen back to its average of the last two decades. The conclusion that has been drawn from all of this is that the economy has less spare capacity than previously thought, meaning inflation will bite earlier in any growth upturn.

This reassessment of potential is a key reason why the RBNZ has significantly revised up its inflation forecasts relative to March (even with the offsetting impact of weaker commodity price forecasts). Annual inflation is now set to return above 2% by mid-2013, much more in line with the range of market forecasts.

Market implications

The statement was more hawkish than the market anticipated, but market pricing was little affected. Markets are far more focussed on the outcome of this weekend's Greek elections. The NZD rose about 20 pips immediately after the release. The two-year swap rate initially rose, but subsequently fell to around eight basis points below the pre-MPS level. This probably reflected the risk-off sentiment in global markets last night.

If the outcome of the Greek election is one that calms markets, then the RBNZ's view on the domestic economy will become relevant. In that scenario, markets will once again take note of the fact that New Zealand's housing market is strong, the Canterbury rebuild implies inflationary pressure, and the RBNZ plans to increase the OCR in 2013.

Media release

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

Reserve Bank Governor Alan Bollard said: "New Zealand's economic outlook has weakened a little since the March *Monetary Policy Statement*.

Figure 2: CPI Inflation

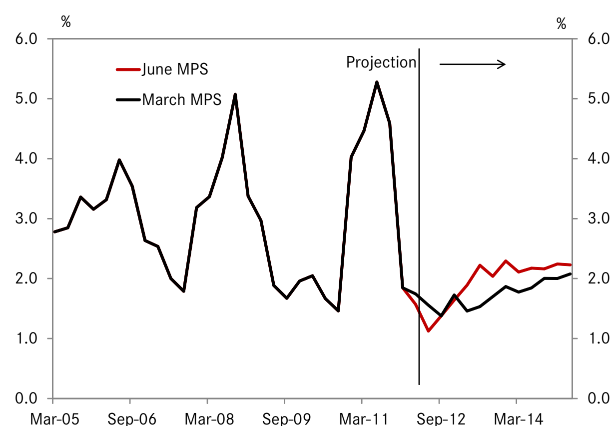


Figure 3: Actual and potential GDP growth

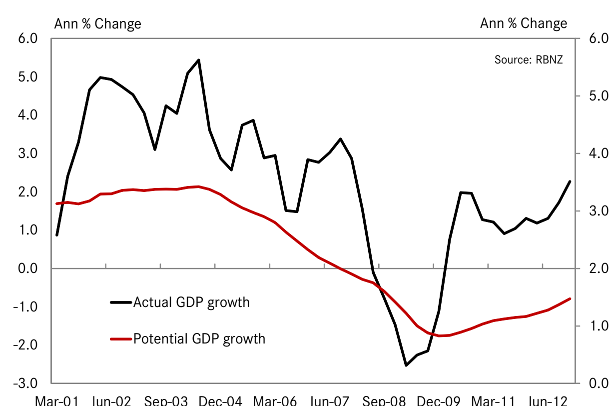
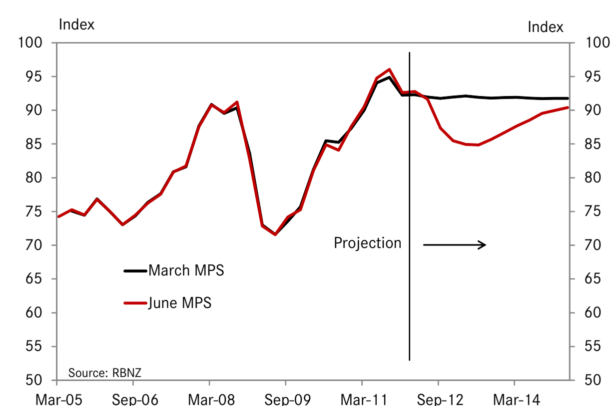


Figure 4: Export prices



"Political and economic stresses in Europe, along with a run of weaker-than-expected data, have seen New Zealand's trading partner outlook worsen. Furthermore, there is a small but growing risk that conditions in the euro area deteriorate more markedly than is projected in the June *Statement*. The Bank is monitoring euro-area developments carefully given the potential for rapid change.

"Increased agricultural production and the weakened global

outlook have driven New Zealand's export commodity prices lower. The resulting moderation in export incomes, although partially offset by depreciation in the exchange rate, will weigh on economic activity in New Zealand. Fiscal consolidation is also likely to constrain demand growth going forward.

"Offsetting these negative influences, housing market activity continues to increase, supported by recent reductions in mortgage interest rates. In addition, repairs and reconstruction in Canterbury are expected to substantially boost construction sector activity in coming quarters. Aggregate GDP growth is projected to pick up slightly to just over 3 percent next year. Given this economic outlook, inflation is expected to settle near the mid-point of the target range.

"It remains appropriate for monetary policy to remain stimulatory, with the OCR being held at 2.5 percent."

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