Westpac

Institutional Bank

Taking it easy

March *MPS* Preview: OCR on hold at 2.50%, hikes pushed out further

- **This Thursday's *Monetary Policy Statement* will expand on the RBNZ's recent indications of a much later start to interest rate hikes.**
- **Inflation pressures have eased significantly in recent months, far outweighing the improved global outlook that financial markets are focused on at present.**
- **The strength of the New Zealand dollar is likely to come in for some particular attention.**

With Reserve Bank Governor Alan Bollard having already said a few weeks back that he doesn't intend to play around with interest rates this year, the thrust of next week's *Monetary Policy Statement* should come as a surprise to no one. The outlook for economic activity is looking a little brighter, and in particular the risk of a catastrophic outcome in Europe has eased. But the inflation picture looks much friendlier than it did a few months ago, and an unexpected surge in the exchange rate has further mitigated the need for policy tightening any time soon. We expect the RBNZ to project a December start to the tightening cycle, which is in line with current market pricing and our own view.

Details

Although this week's *MPS* will be the first full set of forecasts since December, most of the key developments since then occurred before, and were at least touched upon in, the January OCR review. Global market sentiment has improved although the outlook for growth remains fragile, inflation has proven to be well-contained, the high exchange rate is eating into exporters' returns, and the boost to demand from the rebuild of Christchurch may kick in slower than previously thought.

Compared to late last year, when fears of an imminent euro zone break-up were getting a good airing, the financial situation in Europe appears to have stabilised. The leaders have finally reached agreement on the conditions for Greece's debt writedown and bailout package, and the European Central Bank has provided the banks with two rounds of long-term liquidity injections since December. While we think this is far from the end of the story – Greece and others are facing years of grinding austerity, and there is still plenty of scope for the debt agreement to unravel – the 'tail risk' of a catastrophic outcome seems to have been greatly reduced.

One of the biggest potential channels of contagion from Europe to New Zealand is via the cost of overseas funding for our banks. In recent statements, the way the RBNZ has incorporated this mounting risk has been to assume a lower long-term 'neutral' level for the OCR, to counter the impact of higher bank funding costs and end up with a desired level of retail interest rates. With conditions improving in Europe and indicative bank funding costs coming off their peaks, the implication is that the RBNZ could reverse some of this assumption and project a higher end-point for the OCR (the December *MPS* suggested a peak of less than 4%). However, we expect it will move cautiously on this matter for now.

On the domestic front, activity appears to be panning out much as expected. The 0.8% September quarter rise in GDP was more than the RBNZ forecast, but it was offset to some degree by downward revisions to previous quarters. More recent indicators will have given the RBNZ little reason to change its near-term growth forecasts. In its January review the RBNZ acknowledged a modest recovery in consumer spending and house prices, and the evidence for these has strengthened since.

One factor that will weigh slightly on the growth forecasts is that, as spelled out in Dr Bollard's 27 January speech, the RBNZ has softened its assumptions about the pace of reconstruction in Canterbury, in light of the latest swarm of aftershocks in December. The total size of the rebuild job is now larger than before, but as the RBNZ has emphasised, it's the pace of the ramp-up that determines the degree of inflation pressure generated by the rebuild.

We think that weaker inflation will receive the strongest emphasis in the document. The December quarter CPI was much softer than expected (actual -0.3%, RBNZ forecast +0.4%), the second undershoot in a row. And with the impact of the October 2010 GST hike (which added around 2 percentage points) finally dropping out of the calculation, annual inflation fell from 4.6% to 1.8%, well within the 1-3% target range.

It's worth bearing in mind that the current inflation rate isn't that far from what was forecast a year ago. However, prices rose

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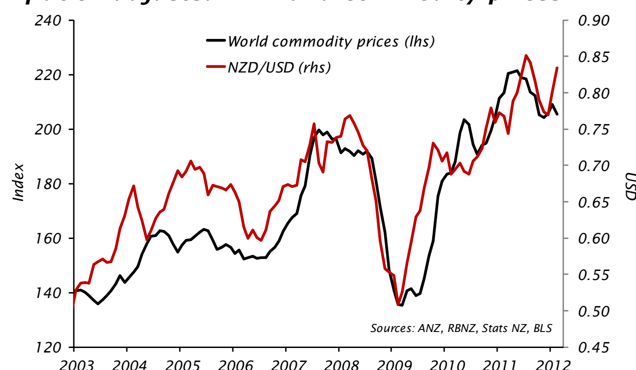
much more than expected in the first half of 2011, and did so in areas (such as construction costs) that looked as though they could be quite persistent. Annual inflation spiked to a 20-year high of 5.3% (including the GST impact), and surveyed inflation expectations followed suit, reaching a peak of 3% for two years ahead. By July, the RBNZ was warning that an OCR hike was imminent. But the worsening in global financial conditions stayed the RBNZ's hand, which proved to be fortunate: inflation pressures were much tamer in the second half of the year, and inflation expectations have also moderated.

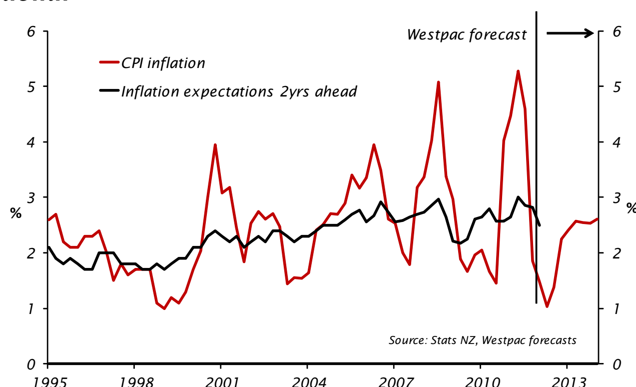
We now expect annual inflation to fall as low as 1% by the middle of this year – partly a legacy of the soft outturns in the last two quarters – before returning just above 2% by year-end. With such a benign near-term inflation outlook, the RBNZ will be very comfortable waiting to see how some of the other risks to the economy resolve themselves.

Inflation-adjusted NZD and commodity prices



The exchange rate will be the other 'dovish' factor in the RBNZ's considerations. The shift in market sentiment on Europe has clearly been a factor behind the rebound in risky assets, including the New Zealand dollar – the trade-weighted index is now around 8% higher than at the time of the December *MPS*. However, the gains in the NZD seem in excess of what could be justified by fundamentals; for instance, world prices for our commodity exports have continued to soften in the meantime. Even the Reserve Bank of Australia, which is typically more agnostic on exchange rates, has commented that the recent strength in the Australian dollar has been "odd" – and the NZD has risen even more than the AUD. It's highly likely that the RBNZ will make some strongly worded comments against the currency's strength.

Inflation-adjusted commodity prices and the NZ dollar



Statement and market implications

Next week's media release is likely to express a similar 'bias' to the January review: "Given ongoing uncertainty around global conditions and the moderate pace of domestic demand, it remains prudent to keep the OCR on hold at 2.5 percent." With inflation well-contained, the RBNZ has plenty of time to ensure that global risks have moderated, and that the Christchurch rebuild is under way, before acting.

Given that most of the significant recent developments were covered in the January review, the RBNZ probably won't dwell on them much further. Conditions have improved slightly in European financial markets, but higher bank funding costs remain a concern; the housing market is showing signs of life; the Canterbury rebuild will eventually add to domestic demand but has faced some delays.

The most likely addition is a stronger statement against the NZD's recent strength. As an example, in July last year, when the currency was at levels similar to today, the RBNZ warned that: "The current very high value of the New Zealand dollar is acting as a drag on the New Zealand economy. If this persists, it is likely to reduce the need for further OCR increases in the short term."

The interest rate projections in the December *MPS* implied hikes from around June this year, with the accompanying media release noting that the OCR was on hold "for now" – a phrase that was dropped from the January statement. We estimate that the RBNZ will push out its interest rate profile by at least two quarters, implying a start no earlier than December.

Ironically, the RBNZ will be significantly softening its message just as financial markets are starting to embrace the idea of rate hikes, with just over half a chance of a December hike priced in. Moreover, the improving sentiment towards the global economy means that the market seems more predisposed toward pushing interest rates higher. We suspect the RBNZ will want to err on the side of a softer tone to next week's statement, to avoid adding further upward pressure to rates in the near term.

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