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Westpac
Institutional Bank

A Goldilocks economy

March *MPS* Review: OCR on hold at 2.50%, RBNZ sees strong growth but few OCR hikes

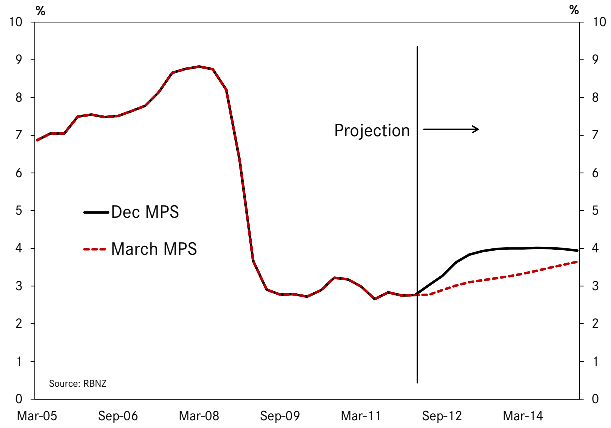
- **The OCR is firmly on hold until at least December this year.**
- **The RBNZ signals strong GDP growth without the need to hike the OCR more than once per year.**
- **We are not so sure the economy has the capacity to grow rapidly without inflationary pressure.**

As expected today's *Monetary Policy Statement* placed more weight on the recent softening in inflation pressures and the strength of the New Zealand dollar than on the easing in global risks that has been buoying financial markets lately. If anything the Reserve Bank went even further than we expected – despite a substantial improvement in the domestic growth outlook, it now expects inflation to remain below 2% for the next few years.

The RBNZ's interest rate projections still imply a December start to OCR hikes, but a glacial pace of tightening after that. We're not so confident that a growing economy will be able to avoid generating inflationary pressures for so long, and we expect that by next year it will become apparent that more tightening work needs to be done.

The RBNZ's new interest rate projections were substantially lower than in the December *MPS*. The 90-day rate is expected to rise to 3% by the December quarter of this year, which is broadly consistent with a 25 basis point OCR hike by then – although the projection is so flat that the hike could plausibly fall a quarter either side of that. From there on, rates are projected to rise at little more than one OCR hike a year – in stark contrast to the short, moderately sharp tightening that was signalled three months ago.

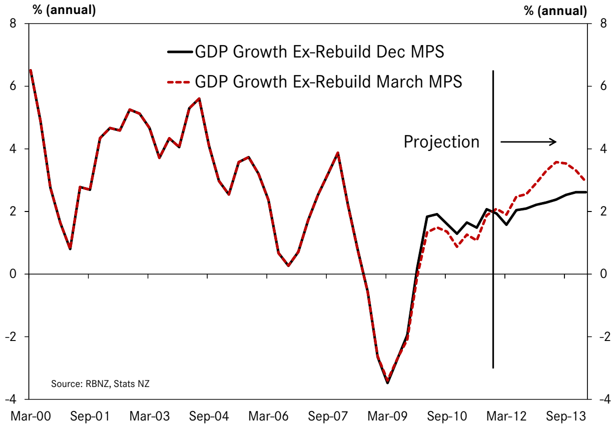
Figure 1: RBNZ 90 day track, March vs December



Source: RBNZ

The RBNZ was upbeat on the economic outlook, and upgraded its GDP forecast to 3.7% in the year to March 2014. The growth upgrade came despite no real change in the global growth outlook, and a downgrade in the RBNZ's expectation for the pace of repair and rebuilding in the Canterbury earthquake zone. Rather, the RBNZ is emphasising recent signs of improvement in the housing market and domestic demand. It now expects house prices to rise 5% this year and to match inflation beyond that, which will fuel stronger growth in consumer spending.

Figure 2: GDP growth ex-rebuild, Mar vs Dec



Source: RBNZ, Stats NZ

This combination of bullish growth forecasts and a dovish interest rate outlook is not as odd as it sounds. Inflation has seriously receded over the past six months. With low inflation, the RBNZ can allow more GDP growth before interest rate hikes are required. The RBNZ also expects a persistently high exchange rate to constrain inflation by keeping the prices of traded goods and services low. With the trade-weighted index having risen around 7% since December and knocking on its all-time highs, harsh words from the central bank were inevitable. The press release did not disappoint, saying that the NZD "is detrimental to the tradable sector, undermines GDP growth and inhibits rebalancing".

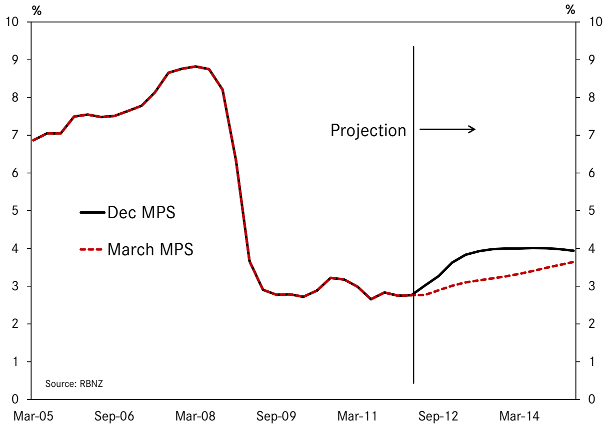
We broadly agree with the RBNZ's assessment of the growth and exchange rate outlook. There is a huge rush of construction activity coming, even if the Canterbury rebuild doers take longer than initially expected. With the housing market steadily warming, it seems reasonable to expect modest growth in consumer spending, off a low base. And although we expect the NZD to dip this year, we agree that high global food prices will support the value of our currency for some time.

Where we are less optimistic is the New Zealand economy's capacity to grow so rapidly without the stresses and strains that inevitably lead to inflation. In particular, there are serious question marks around the economy's capacity to handle the Canterbury rebuild. We fear that the rebuild will strain the economy's spare capacity sooner, driving up costs and wages and generating inflationary pressures.

There are shades here of the lead-up to the previous tightening cycle, in late 2003. In the face of clear evidence that the domestic economy was accelerating, the RBNZ held back on hiking the OCR for fear of stoking what was already considered to be an overvalued exchange rate. In the end, rising house prices and a construction boom fuelled domestic inflation and the OCR ended up going much higher than markets or the RBNZ anticipated. It would be too glib to claim that history will repeat, but we feel there is a growing risk in that direction.

We are hardly alone in our relatively pessimistic view of this economy's ability to grow without stoking inflation. The RBNZ demonstrated that all private sector forecasters were predicting higher inflation, despite many being more downbeat on GDP growth.

Figure 3: CPI forecasts, RBNZ vs Westpac



Source: RBNZ

But for now, the central bank must be taken at its word. The OCR is firmly on hold until December 2012 at the earliest. The RBNZ's benign views on inflation won't face an evidential test until 2013.

Markets were slightly surprised by the dovish tone of the *MPS*, although it was really seen as a case of the RBNZ stepping into line with existing market pricing. Two-year swap rates fell 5 basis points and the exchange rate fell 0.4 cents against the US dollar.

Media release

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.
Reserve Bank Governor Alan Bollard said: "Inflation has settled near the middle of the Bank's target range, and inflation expectations have fallen.

"The domestic economy is showing signs of recovery. Household spending appears to have picked up over the past few months and a recovery in building activity appears to be underway. That recovery will strengthen as repairs and reconstruction in Canterbury pick up later in the year. High export commodity prices are also helping to support a continuing recovery in domestic activity.

"Policy actions from a number of central banks have boosted global confidence. While encouraging, financial market sentiment remains fragile and risks to the global outlook remain. Furthermore, the easing in global monetary policy and resultant recovery in risk appetite has contributed to a marked appreciation in the New Zealand dollar.

"While helping contain inflation, the high value of the New Zealand dollar is detrimental to the tradable sector, undermines GDP growth and inhibits rebalancing in the New Zealand economy. Sustained strength in the New Zealand dollar would reduce the need for future increases in the OCR.

"Given the medium-term outlook for inflation, it remains prudent to hold the OCR at 2.5 percent."

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