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Westpac Institutional Bank

No idle threat

Apr 26 OCR review: RBNZ on hold, strong NZD becomes crucial

- **The RBNZ left the cash rate on hold at 2.50% and removed all reference to a tightening bias.**
- **The persistent strength of the New Zealand dollar is a growing concern for the RBNZ in its own right. Depending on how the exchange rate evolves, OCR cuts and/or forex intervention can't be dismissed in the near term.**
- **But in our view the most likely scenario is that the OCR remains on hold through this year.**

Today's OCR review statement was brief but it contained some strongly worded messages. The first: it's no longer a given that the next move in the OCR will be up. The second: what happens with the exchange rate is crucial. All else equal, a persistently strong New Zealand dollar could bring on a policy response.

Markets are now pricing in a 40% chance of an OCR cut before the end of RBNZ Governor Bollard's term in September. We broadly agree with the market's assessment of risks; while we don't believe that a rate cut would be effective or appropriate, it has to be regarded as a meaningful risk in the near term.

Whether the OCR is cut this year or not, our expectation is for an extensive series of OCR hikes over the 2013-2015 period. Interest rates remain well below neutral levels, and the impending construction boom is likely to be more inflationary than the RBNZ is conceding (this will be more of a driving force in later years than it will be this year).

Details

As we expected, the persistently high exchange rate was the deciding factor in today's statement. The NZ dollar has largely held around the same levels since the March Monetary Policy Statement, despite further falls in export commodity prices and renewed signs of stress in global markets. The key statement was:

"Should the exchange rate remain strong without anything else changing, the Bank would need to reassess the outlook for monetary policy settings."

Given that the outlook in March was for little more than one OCR hike a year for the next three years, it wouldn't take much of a reassessment for the RBNZ to be projecting lower interest rates in its next set of published forecasts in June.

What's more, the statement noted that keeping the OCR on hold was appropriate "for now"; previous statements have put no timeframe on this. We think that choice of words is intentional: the last time they appeared was in June 2011, followed by a July statement that effectively said that the RBNZ was preparing to hike in September. (As it happened, an escalation of the US and European sovereign debt crises in the following weeks put paid to that – the caveat "without anything else changing" always applies.)

It's important to note that domestic conditions are not behind the RBNZ's shifting bias. The statement reiterated that inflation is expected to stay "near the middle" of the 1-3% target range. The housing market is strengthening and building activity is picking up, which is entirely in line with the RBNZ's expectations (as we've noted elsewhere, the RBNZ's GDP growth forecasts are actually stronger than for most private sector forecasters).

Since neither weak growth nor an undershoot of the inflation target are part of the RBNZ's central view, it appears that the RBNZ regards a strong NZ dollar as a bad thing in its own right. The Governor has two broad options for addressing this: lowering interest rates, or directly intervening in the exchange rate. We suspect that both of these are on the table, although not necessarily imminent.

We doubt that interest rate cuts would be all that effective in tackling the high exchange rate, and could even be counterproductive. Lower interest rates would further fuel the strengthening housing market, ultimately requiring more rate hikes in the future. But we wouldn't rule it out given the precedent that has already been set: the central bank of Norway has twice cut rates in response to its strong exchange rate, even as house prices continue to climb and private sector debt is forecast to reach an eye-watering 200% of disposable income this year.

As for intervention, this has always been a possibility, but no more or less so as a result of today's statement. In 2007 the RBNZ published its policy on active intervention in the exchange rate, setting out four criteria for deciding when to act: the exchange rate should be extremely high or low, unjustified by fundamentals, intervention should be consistent with the inflation target, and done when market conditions give it a reasonable chance of success. While the RBNZ hasn't made reference to these criteria lately, our view is that all four have probably been met, more so than any other time in recent years (for instance, consistency with the inflation target would have been a sticking point through much of last year, when annual inflation peaked at 5.3%). However, the Prime Minister has recently commented that he wouldn't support such a move.

Market implications

The two-year swap rate fell 8 basis points to 2.78% after the statement, and short-term rates imply a 40% chance of an OCR cut by Dr Bollard's last review in September. However, the NZ dollar has held up and actually rose slightly after the release.

A possible reason for this mixed response is that the market sees less risk of intervention, given that the RBNZ didn't make mention of it. We'd disagree with that interpretation – cutting the OCR to weaken the exchange rate doesn't rule out using intervention as well, and in any case the RBNZ has repeatedly said that it doesn't discuss intervention.

Our view is that markets should be alert to the possibility of FX intervention in the near term (and an overwhelming body of research shows that the impact of intervention tends to fade within a few days, so there would be limited opportunities to benefit from it). But more significantly, the risk of a rate cut if developments in the exchange rate don't go the RBNZ's way should be taken seriously.

RBNZ media release

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

Reserve Bank Governor Alan Bollard said: "Inflation is restrained and is expected to stay near the middle of the Bank's target range.

"The domestic economy is showing signs of recovery. Housing market activity continues to increase and a recovery in building activity appears to be underway, as forecast. That recovery will strengthen as repairs and reconstruction in Canterbury pick up later in the year.

"However, the global outlook remains of concern. Near-term indicators have moderated and financial market sentiment is still fragile.

"The New Zealand dollar has stayed elevated despite recent falls in commodity prices. Should the exchange rate remain strong without anything else changing, the Bank would need to reassess the outlook for monetary policy settings.

"For now, it is appropriate for the OCR to remain at 2.5 percent."

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