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Westpac

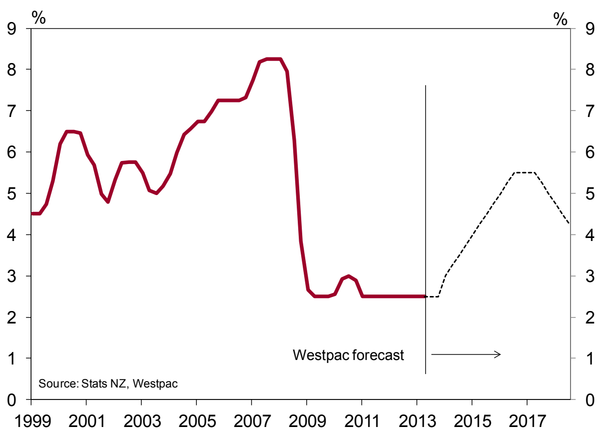
Institutional Bank

A fickle master

October 2013 OCR Review: OCR unchanged at 2.50%

- The stance of monetary policy is unchanged – the RBNZ expects to increase the OCR next year.
- The exchange rate was introduced as a new factor that could affect the timing and magnitude of future OCR hikes, alongside the housing market and the construction sector.
- This was as we and markets anticipated. The exchange rate jumped rather inexplicably, but interest rates did not change.
- We are now forecasting an April start date to the OCR hiking cycle. This puts us on the same page as the RBNZ, while other economists are forecasting a March start date.

Westpac OCR forecast



The Reserve Bank's October OCR Review was very much in line with our preview and with market expectations.

The basic message was the same as that delivered in the September *Monetary Policy Statement (MPS)*. The OCR will have to go up next year, but the exact timing and extent of the hiking cycle depends on the degree to which the buoyant housing market and construction sector generates inflation pressure. The RBNZ did upgrade slightly its forecast of near-term economic growth, and noted that inflation had risen to 1.4%. But these were mere acknowledgements the latest data developments, rather than representing a change in the stance of monetary policy.

There was one substantive change compared to the September *MPS*. The RBNZ introduced an entirely new sentence pointing out that the future trajectory of the OCR would depend on what happened to the exchange rate:

"Sustained strength in the exchange rate that leads to lower inflationary pressure would provide the Bank with greater flexibility as to the timing and magnitude of future increases in the OCR."

We consider it prudent of the RBNZ to discuss the exchange rate in a conditional manner, rather than making a wholesale change to the stance of policy. Exchange rates are fickle, and responding to every gyration can make a central banker look like a flip-flopper.

Given that the exchange rate had risen substantially over the past couple of months, the tone of the October OCR Review was entirely unsurprising. Interest rate markets did not react at all to the Review. However, we were bemused by the currency market reaction, which saw the New Zealand dollar jump 0.4 cents against the US dollar. This was either an artefact of market positioning, or a kneejerk reaction to the final paragraph of the Review, which was similar to the September *MPS*. Either way, we don't think the exchange rate reaction was warranted.

Westpac's OCR call

As we foreshadowed last week, we are altering our own OCR forecast. We now expect the RBNZ will begin hiking the OCR in April next year (previously March). We still believe that the construction boom and rising house prices will provoke inflation pressures, eventually requiring the RBNZ to engage in a substantial OCR hiking cycle. But like the RBNZ, we have become more concerned about the effect on near-term inflation of the high exchange rate. Our forecast is that the TWI will be above 78 in March, as the dichotomy between a weak US economy and a strong New Zealand economy persists. With the exchange rate at that level, we doubt that the Reserve Bank would be prompted into hiking the OCR early.

Our call for an April start date for the OCR hiking cycle puts us pretty much on the same page as the RBNZ, while most other economists are forecasting a March hike.

Monetary policy, inflation, and exports

There was one aspect of today's OCR Review that deserves special mention – the way it explicitly linked the exchange rate to inflation. In the past, the RBNZ tended to express its concern about the exchange rate in terms of the plight of exporters. Such sympathetic comments probably garnered political favour, but they were very confusing to markets. It sounded as though the RBNZ was targeting the exchange rate or exports, rather than targeting inflation. Those comments also gave false hope that the conduct of monetary policy could actually affect New Zealand's export performance in a sustained manner – as though all that was required to compete in a brutal global marketplace was a casual stroke of the Reserve Bank Governor's pen, rather than old-fashioned hard graft. Of course, every New Zealand policy maker should be concerned with maximising New Zealand's export competitiveness. But the reality is monetary policy is not the tool for doing so. We welcome the RBNZ's increasing tendency to clarify that stable inflation is (and should be) the primary goal of monetary policy.

RBNZ media release

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

Reserve Bank Governor Graeme Wheeler said: "The recovery in the United States and other major advanced economies remains patchy. Nevertheless, world prices for New Zealand's export commodities are very high.

"Global long-term interest rates are still very low, but have been volatile recently. This volatility has largely been due to uncertainty as to when the Federal Reserve will exit from quantitative easing.

"The New Zealand economy is estimated to have grown by more than 3 percent in the year to September. Household spending is rising, and reconstruction in Canterbury is being reinforced by a broader rise in construction in Auckland and across the country more generally. This will support economic activity and start to ease the housing shortage.

"In the meantime high house price inflation persists, especially in Auckland. As has been noted for some time, the Reserve Bank does not want continued high house price inflation to compromise financial or price stability. Recently introduced restrictions on high loan-to-value mortgage lending are expected to help slow house price inflation and the Bank will continue to monitor the situation closely.

"The exchange rate remains high and is a headwind to the traded goods sector. Sustained strength in the exchange rate that leads to lower inflationary pressure would provide the Bank with greater flexibility as to the timing and magnitude of future increases in the OCR. Fiscal consolidation is also expected to continue weighing on demand over the next few years.

"Annual CPI inflation increased to 1.4 percent in the September quarter. As domestic demand pressure picks up, headline inflation is likely to rise towards the 2 percent target midpoint. The Bank is aiming to keep inflation and inflation expectations close to 2 percent over the medium term.

"Although we expect to keep the OCR unchanged in 2013, OCR increases will likely be required next year. The extent and timing of the rise in the policy rate will depend largely on the degree to which the momentum in the housing market and construction sector spills over into broader demand and inflation pressures."

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