Cat among the pigeons
RBNZ July 2014 OCR preview

- A spate of weak data has raised legitimate questions about the appropriate pace of OCR hikes in New Zealand.
- Next week’s July OCR Review is no longer a “done deal”. However, on balance we still believe the RBNZ will hike the OCR by 25 basis points.
- The accompanying press release will restate the RBNZ's main message that, over the coming years, the OCR is likely to rise substantially.
- However, the RBNZ will probably also state that it intends to briefly pause the programme of OCR hikes after July.
- We now expect this pause will last until January 2015 (previously December 2014).
- The RBNZ might consider intervening in currency markets by selling New Zealand dollars after the July OCR Review.

The July OCR Review was supposed to be a slam dunk. After the June Monetary Policy Statement, we were left in no doubt that the Reserve Bank planned to hike the OCR by 25 basis points at the July OCR Review – unless, of course, some extreme data surprise came along to cancel the hike.

Since June, there has not been any single event that could be categorised as “extreme”. But over the past few weeks New Zealand has experienced a constellation of economic developments that, in unison, does raise questions about the urgency for OCR hikes.

Most important among these developments is precipitous declines in dairy and log export prices. This is quite different to the period of falling dairy price in March and April – that was anticipated by the Reserve Bank, whereas the latest episode was not. To make matters worse for exporters, the exchange rate is now even higher than it was early in the year.

On the domestic front, the economy has lost some of its (considerable) momentum, and the Consumers Price Index has failed to produce a “smoking gun” of accelerating non-tradables inflation. Fixed mortgage rates, which had been too low for the Reserve Bank’s liking, have risen sharply. The solitary “upside” development of the past few weeks has been net immigration, which has again turned out stronger than the RBNZ anticipated.

After mulling this plethora of downside developments, we are sure that the Reserve Bank will conclude that the requirement for OCR hikes has attenuated – but has not been eliminated. The June MPS showed that the RBNZ expected to lift the OCR by 1.5 percentage points over the next two years. The requirement may now be for the OCR to rise by only 1.25 percentage points.

The latest data developments may even provoke a lively discussion within the RBNZ as to whether an OCR hike next week is still warranted. But ultimately, we think the RBNZ will proceed with the hike, for the following reasons:
• The current RBNZ administration has built an admirable record of clear and accurate communication regarding future OCR changes. Failing to hike next week would risk squandering that hard-won credibility.

• The RBNZ has always maintained that its hiking cycle would be “front-loaded” – that is, OCR hikes would be rapid at first, and slow later. There is no reason to shy away from that strategy.

• In an alternative scenario within the June MPS, the RBNZ indicated what it would do if export prices deteriorated unexpectedly. In that scenario, the RBNZ indicated it would still hike the OCR in a front-loaded fashion, but would proceed with a slower pace of OCR hikes later.

Although we expect the RBNZ to persist with its hike next week, the recent bout of weaker data has strengthened the case for a “pause” in the OCR hiking cycle beyond July. Such a pause was always the RBNZ’s plan. Whereas we previously expected the hiking cycle to resume in December 2014, we now anticipate a lengthier pause. At the end of this year we expect inflation will still be just 1.6%, and we doubt that the housing market will rebound as vigorously as the RBNZ fears.

We are now forecasting the OCR to remain at 3.5% from July until January 2015 (see table).

Westpac OCR forecast

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<thead>
<tr>
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<th>Previous Forecast</th>
<th>Current Forecast</th>
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<tr>
<td>July 2014</td>
<td>3.5%</td>
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<td>3.5%</td>
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<td>June 2015</td>
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RBNZ communication

The one-page press release accompanying the OCR decision will of course acknowledge the various economic developments that have conspired to weaken the inflation outlook. In particular, the RBNZ is sure to decry the inconsistency between the stratospheric New Zealand dollar and deteriorating export conditions.

When it comes to the OCR outlook, the RBNZ will attempt to find a way of clearly signalling a pause, while reaffirming the overarching message that the OCR will rise gradually over the coming years. The RBNZ always places a high premium on providing clear guidance about upcoming OCR decisions, because this helps to control interest rates. But there is a second motivation for clarity in the current circumstances – the September MPS is nine days before a general election. The best way for the RBNZ to avoid becoming a political football and stay out of the headlines is to ensure there are no newsworthy surprises on the day.

The RBNZ seems pretty good at delivering such nuanced messages – in the past it has simply bluntly stated its intention. For example, the October 2013 OCR Review could not have been clearer: “Although we expect to keep the OCR unchanged in 2013, OCR increases will likely be required next year.”

The RBNZ may take a similar approach next week. Our attempt at drafting the “bottom line” of the OCR Review reads something like:

“For now, a short period of stability in the OCR seems appropriate. Over time, further OCR increases are likely to be needed to keep future average inflation near the 2 percent target mid-point. The speed and extent to which the OCR will need to rise will depend on future economic and financial data, including the exchange rate, and their implications for inflationary pressures.”

Market reaction to a statement along these lines would be slight.

A word on currency intervention

Once the July OCR Review is out of the way, the RBNZ may consider intervening in foreign exchange markets by selling New Zealand dollars. This would address the real nub of the Reserve Bank’s current problem – that the exchange rate refuses to fall even as export conditions are deteriorating. The RBNZ has often mentioned that it would prefer a different mix of monetary conditions, involving higher interest rates to restrain the housing market and a lower exchange rate.

The RBNZ has four formal criteria for currency intervention. (1) The exchange rate must be extreme; (2) it must be unjustified; (3) intervention must be consistent with the aims of monetary policy; and (4) intervention must be opportune (ie, it would work). We would add an informal fifth condition that intervention has to have a decent chance of proving profitable in the long run.

We would argue that the first three formal conditions have long been satisfied, as has the informal fifth condition. However, the requirement that intervention would actually work has been doubtful. Selling New Zealand dollars today and then hiking the OCR next week would certainly be intervention harakiri. But once the RBNZ officially pauses its OCR hiking cycle, opportune moments could arise. For example, if market positioning comes to suggest that the New Zealand dollar is vulnerable to a fall, the RBNZ might well take the opportunity to intervene and so catalyse a fall.

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