Westpac Institutional Bank

Taking a back seat

September 2013 Monetary Policy Statement preview

- **The September MPS will likely foreshadow earlier OCR hikes than the June MPS, but will be similar in tone to the July OCR review.**
- **Activity and inflation data have been strong, but LVR restrictions and higher fixed mortgage rates could cool the housing market.**
- **The RBNZ's best strategy is to wait and see. Monetary policy can take a back seat for now.**
- **The overall message will be "hikes are coming, but not this year".**
- **Such an MPS would not provoke much market reaction.**

For most of this year the Reserve Bank has maintained a "firmly on hold" outlook for the Official Cash Rate (OCR). Monetary policy was stuck between a rock and a hard place. The high-and-rising exchange rate had pushed inflation below the Reserve Bank's 1% to 3% target range, but the Canterbury rebuild and rapid house price inflation threatened to generate inflation over the medium term.

Westpac has long emphasised the latter. Over the decades housing and construction booms have consistently been associated with rising inflation, and we see no convincing reason that this time will be different. So we have long been warning that interest rates would need to rise toward average levels.

But the Reserve Bank has felt otherwise. Its thinking has been driven by four key assumptions:

- The Canterbury rebuild would be orderly rather than inflationary.
- Rising house prices would fail to excite much consumer spending, and in any case the housing market would soon cool.
- The exchange rate would remain high.
- Fiscal policy would remain a drag on the economy.

The last of these assumptions is still looking good, but the others have been seriously challenged, particularly since the June *Monetary Policy Statement* (MPS). The June quarter Consumer Price Index raised a red flag around the construction-related inflation, which was up sharply across the whole of New Zealand rather than just Canterbury. Clear evidence has emerged to show that households are indeed leveraging up and spending on the back of house price inflation. And instead of remaining high the exchange rate has fallen almost 5% on a trade weighted basis.

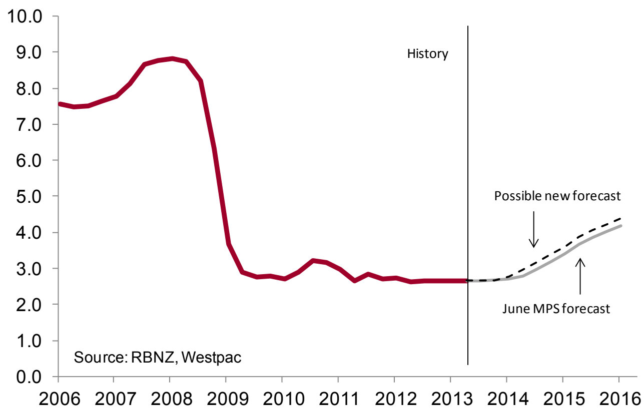
The calculus has changed in other ways, too. The general tone of domestic economic data has probably been even stronger than the RBNZ's already-bullish forecasts. The dairy industry now seems likely to pull in bumper incomes this year. And the RBNZ's survey of expected inflation in two years time leapt unexpectedly from 2.1% to 2.4%.

Some of these developments were already apparent at the July OCR review, and the Reserve Bank did change tack at that time. For the first time since 2011 it explicitly mentioned OCR hikes in the "bottom line" bias paragraph of the press release:

"Although the removal of monetary stimulus will likely be needed in the future, we expect to keep the OCR unchanged through the end of this year."

In next week's September MPS we expect the Reserve Bank will reiterate and formalise the main message from the July OCR Review. But we do not expect the RBNZ to lean any further in the direction of OCR hikes. In fact, we expect the bottom-line bias paragraph will be similar in spirit to the July paragraph quoted above. And we anticipate a 90-day interest rate forecast that is only 10 to 20 basis points higher than the forecast delivered back in the June MPS.

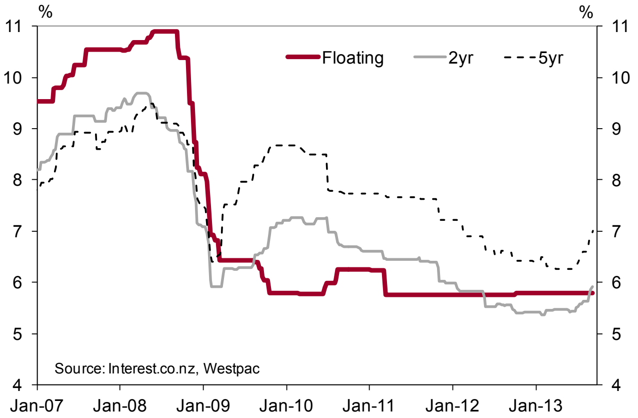
RBNZ 90-day rate forecast



To be sure, the RBNZ is likely to repeat the bullish tone on the economy that appeared in July, and will probably make mention of higher dairy incomes. A warning shot may even be fired at inflation expectations, with something along the lines of "the Bank would like to see inflation expectations settle near the 2% inflation target."

But such hawkish commentary will be tempered by the elephant in the room – the MPS will mention that the outlook for house prices has weakened on two fronts. First, the RBNZ recently restricted bank lending to low-equity borrowers. Second, fixed mortgage rates have risen sharply in recent weeks. Either or both of these developments have the potential to slow house price inflation – but it is too soon to discern the magnitude of any impact just yet.

Average advertised mortgage rates



We believe the Reserve Bank's best response to these developments will be to wait and see what happens before committing to a change in monetary policy. The impact of LVR restrictions on the housing market is highly uncertain, but with inflation currently below target and forecast to rise slowly, the RBNZ has time on its side and can afford to take a back seat while the LVR restrictions work through the system.

This MPS will also be designed as one that does little to alter current financial market pricing. Financial markets may be pricing in a more aggressive series of OCR hikes than the RBNZ deems necessary, but the central bank will probably see the recent rises in fixed mortgage rates as expedient in its desire to cool the housing market without pushing the exchange rate higher. Again, there is no need to make waves at this time.

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