Westpac Institutional Bank

Shine a light

September 2013 MPS Review: OCR unchanged at 2.50%, hikes likely next year

- **The Reserve Bank delivered a clear message today that it is likely to begin an extended series of interest rate hikes from next year.**
- **The September *Monetary Policy Statement* fleshed out the shift in stance that was signalled in the July OCR review.**
- **The RBNZ is becoming more concerned about the inflation consequences of the construction boom and rising house prices – even with loan restrictions and higher mortgage rates leaning against the latter.**
- **Our long-held view that OCR hikes will begin in March 2014 is now broadly matched by the RBNZ's projections, as well as market pricing.**

The last Official Cash Rate (OCR) review in July marked a shift in the Reserve Bank's monetary policy stance, introducing an explicit discussion of interest rate hikes for the first time since late 2011. For the most part, today's Monetary Policy Statement (*MPS*) served to shed light on just how significant that July shift was – if anything, upping the ante slightly on the case for rate hikes.

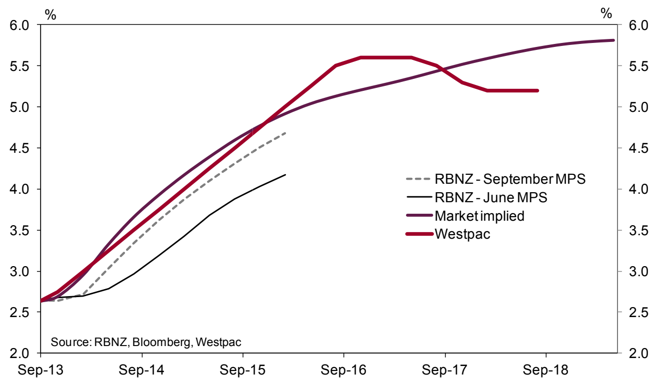
As for what's prompted the change in stance – in part it's a growing confidence that the New Zealand economy has entered a sustained upturn, aided by a construction boom and rising house prices. But there's also a sense that the RBNZ's long-held assumptions that these two forces would have benign inflationary effects are now being challenged. That means that even with a slightly softer outlook for house price growth – thanks to the recent loan restrictions and higher fixed-term mortgage rates – the degree of upward pressure on inflation is seen as more severe than in June.

Details

The bottom line of today's statement largely retained the language used in July. Firstly, the OCR is expected to remain unchanged this year, but hikes "will likely be required next year". Secondly, there's no longer any question about the direction of the next move in rates, only the degree: "The extent and timing of the rise in policy rates 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".

The most telling measure of how the RBNZ's view of the world has shifted in recent months is in its projections for the 90-day interest rate. Compared to the pallid series of OCR hikes that was projected in the June *MPS*, today's statement projected a substantial tightening cycle beginning around April next year and proceeding at a pace equivalent to one OCR hike per quarter. By the early 2016 cut-off for the published forecasts, the 90-day rate is projected to be at 4.7% (and rising) – a full 50 basis points higher than what was projected in June. That now puts the RBNZ broadly in line with our forecast of an extended tightening cycle from March 2014.

90-day rate expectations



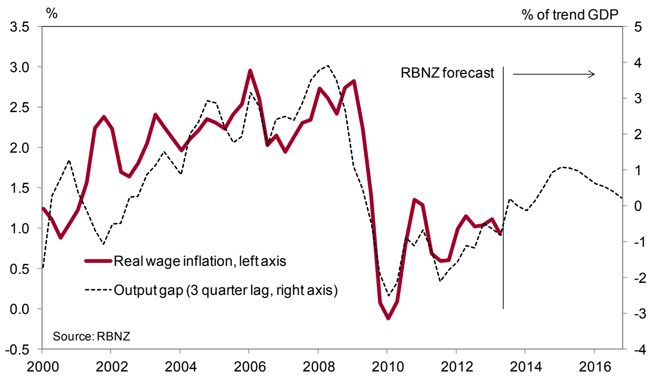
The RBNZ's other economic forecasts were less revealing in themselves, with only modest changes to the outlook for GDP growth, unemployment and inflation compared to the June *MPS*. All together, this suggests that the RBNZ sees substantially more inflation pressures developing over the next few years, but has chosen to offset these pressures through higher interest rates.

The RBNZ expects annual GDP growth to accelerate to 3% by the year to September 2013, peaking at 3.5% by mid-2014. At least in the near term, those growth forecasts are likely to be disappointed – the *MPS* estimates 0.4% growth in the June quarter GDP figures released next week, but data received since the forecast was finalised suggests that growth will be closer to zero. (We expect a 0.1% decline, which we'll detail in our preview tomorrow.) Annual inflation is expected to return above 1% in the September quarter, partly due to higher fuel prices and the recent drop in the New Zealand dollar, but only rising gradually from there to the 2% midpoint of the RBNZ's target band.

The apparent lack of impact from the lower exchange rate may come as a surprise to some, given that in the past the RBNZ has made much of the idea that even a modest upside surprise on the exchange rate could warrant interest rate cuts. The actual relationship is more complex than that, however. The recent fall in the dollar creates a bit more upward pressure on prices in the near term. But going forward, a stronger interest rate track means that the RBNZ expects the currency to depreciate more slowly than in the June projections. The slower rate of declines actually implies a lesser rate of increase in the prices of tradable goods and services.

All together, the RBNZ seems increasingly confident that the economy has entered a sustained upswing, aided by a construction boom in Canterbury and elsewhere. It estimates that activity has now by and large returned to its non-inflationary 'potential' level, and will rise above this point in coming years, putting more upward pressure on wages and prices.

Output gap and annual real wage inflation – RBNZ forecast



But that picture hasn't changed dramatically in the last few months. Rather, what seems to have prompted the RBNZ's more hawkish stance is that some of its long-held assumptions are coming under threat. The RBNZ had taken the view that rising house prices would not provoke much extra consumer spending, and that the Canterbury rebuild would prove less inflationary than past construction booms. In contrast, we've long been saying that the inflationary effects of this cycle would be no different to past cycles. The recent evidence has been more in favour of our view, and by the July OCR review the RBNZ was acknowledging that too.

LVR restrictions

Perhaps the most challenging development since June is the introduction of restrictions on high loan-to-value (LVR) mortgage lending, which were announced in August. While the stability of the banking system is the primary motivation for these new rules, the RBNZ has made it clear that a slowdown in the rate of house price growth will be the measure of their success – and a slowdown in the housing market would have implications for monetary policy to the extent that it affects household consumption and housing-related price pressures.

The RBNZ's forecasts assume that the LVR restrictions will reduce the rate of house price inflation by 2.5 percentage points over the next year, making the tightening effect of the restrictions equivalent to 30 basis points' worth of OCR hikes. Those figures are telling, for two reasons. Firstly, the fact that the RBNZ could raise its interest rate track by as much as 50 basis points, even after lopping off 30 points for the LVR restrictions, indicates that they perceive a great deal more inflation pressure relative to the June *MPS*. Secondly, it suggests that the RBNZ's forecasts have become more sensitive to house price inflation than they may have been in the past – otherwise, it's hard to see how they could have been so sanguine about the surge in house prices up until the June *MPS*.

The RBNZ's house price forecasts are actually only slightly softer than they were in June – a stronger underlying picture partly offsets the impact of both the LVR restrictions and the substantial rise in fixed-term mortgage rates in the last few months. That said, that RBNZ seems more confident that house price growth is close to peaking and will slow next year. We're inclined to agree – the rise in mortgage rates puts the housing market much closer to being fairly valued than it was even three months ago.

We agree with the RBNZ's new stance. We have long argued that rising house prices and a construction boom would eventually provoke inflation pressures and would require a substantial OCR hiking cycle, similar to the experience of past decades. It is right for the central bank to warn markets and the public that a period of higher interest rates is coming. Indeed, moving early in this manner may limit the eventual extent of OCR hikes that are required – the anticipation of future OCR hikes has caused markets to push fixed mortgage rates up, which will slow the housing market earlier than OCR hikes on their own could have.

Market implications

Markets viewed the statement as slightly more hawkish than expected. Swap rates rose by 2 basis points, and the NZD/USD exchange rate jumped half a cent to 0.8130. Interest rate markets are fully pricing in a 25bp hike by March next year, and are toying with the possibility of an even earlier move.

We suspect that the burden of proof for kicking off a tightening cycle earlier than March is fairly demanding – for one thing, it would pay to see what impact the LVR restrictions have as they are phased in over coming months. Moreover, the RBNZ can already successfully guide market interest rates higher through clearly signalling its intentions; it has little to gain – and much to lose in terms of reputation – by going back on its expectation for no OCR hikes this year. So we'd rule out a December OCR hike, but it's increasingly likely that rate hikes will kick off early next year.

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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 global outlook remains mixed. GDP growth in Australia and China has slowed and some emerging market currencies have come under considerable downward pressure. At the same time, the major developed economies continue to recover and New Zealand’s export commodity prices remain very high.

“Although long-term interest rates have risen globally in recent months, largely due to uncertainty around the timing of the Federal Reserve’s exit from quantitative easing, global financial conditions overall continue to be very accommodating.

“In New Zealand, GDP is estimated to have increased by 3 percent in the year to the September quarter. Consumption is rising and reconstruction in Canterbury will be reinforced by a broader national recovery in construction activity, particularly in Auckland. This will support aggregate activity and start to ease the housing shortage.

“In the meantime rapid house price inflation persists in Auckland and Canterbury. As has been noted for some time, the Reserve Bank does not want to see financial or price stability compromised by continued high house price inflation. Restrictions on high loan-to-value residential mortgage lending, which will come into effect next month, are expected to help slow the national housing market.

“Despite having fallen on a trade-weighted basis since May 2013, the exchange rate remains high. A lower rate would reduce headwinds for the tradables sector and support export industries. Fiscal consolidation will weigh on aggregate demand over the projection horizon.

“CPI inflation has been very low over the past year, partly reflecting the high New Zealand dollar and strong international and domestic competition. However, inflation is expected to rise towards the mid-point of the 1 to 3 percent target band as growth strengthens over the coming year.

“OCR increases will likely be required next year. The extent and timing of the rise in policy rates 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. We expect to keep the OCR unchanged in 2013.”

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