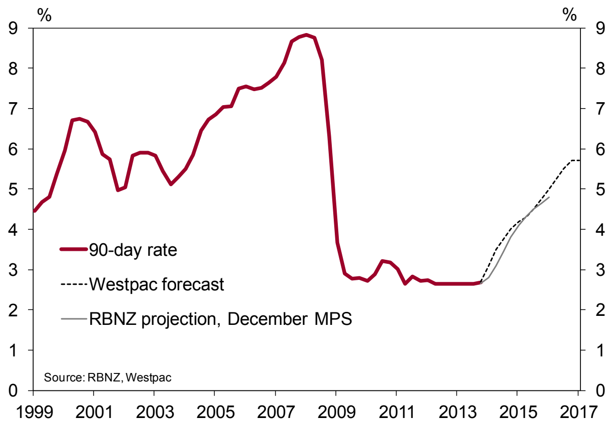
Westpac Institutional Bank

This is it

March 2014 *MPS* preview: OCR to rise 25bps to 2.75%

- The Reserve Bank is widely expected to lift the Official Cash Rate to 2.75% in next Thursday's *Monetary Policy Statement.*
- This will be the first in an extended series of hikes over the next few years, to head off the inflation pressures generated by the strengthening economy and the Canterbury rebuild.
- We expect the language of next week's statement to be quite clear about the likelihood of consecutive OCR hikes over the next few review dates.

90-day rate projections



In next Thursday's *Monetary Policy Statement (MPS)* the Reserve Bank will finally begin the journey back to more normal interest rate settings, after several years of economic underperformance, false starts and major setbacks. With the RBNZ having stated in January that this adjustment process will begin "soon", market participants are now widely anticipating an increase in the Official Cash Rate (OCR) from 2.50% to 2.75%.

Indeed, this would have to be a contender for the most well-signalled monetary policy move in this nation's history. Interest rate markets have been tipping a March start date for several months, homeowners are reportedly fixing their mortgage rates in greater numbers, and the latest ANZ Business Outlook found that a net 90% of firms expect interest rates to rise over the next year – the highest reading in the 21-year history of this survey question.

The more important message in next week's *MPS* will be around the pacing of future OCR moves once the tightening cycle is under way. While the RBNZ's projected path of interest rate hikes could still reasonably be described as 'gradual' compared to past tightening cycles, it won't leave much room for dallying – consecutive hikes at some stage are a given, and in our view are more likely to occur up front.

With that in mind, the RBNZ won't want to leave markets and the public in any doubt as to the prospect of follow-up hikes at the next few OCR review dates. Since its economic projections alone aren't sufficiently detailed to convey that message, the RBNZ will need to be fairly clear with its words. We suggest that the 'bias' paragraph of the media statement accompanying the *MPS* could be along these lines:

"The Bank will increase the OCR further in upcoming reviews, as needed to keep future average inflation near the 2 percent target mid-point. The scale and speed of the rise in the OCR will depend on future economic indicators."

Such a statement would support our expectation of four consecutive hikes of 25 basis points between now and July.

Financial markets are not quite fully pricing in follow-up hikes, so the reaction on the day could be a small lift in short-term interest rates and the New Zealand dollar.

Forecast details

The December 2013 *MPS* projected above-trend GDP growth for the next two years, a gradual return to the 2% mid-point of the inflation target by late 2015, and just over 200bp of interest rate hikes over the next two years (implying somewhere between four and five OCR hikes in 2014). The March *MPS* is likely to feature an upgrade in the RBNZ's assessment of inflation pressures, which will at least in part be countered by a higher interest rate track.

GDP growth over the near term is tracking a little stronger than the RBNZ expected. More generally, leading indicators of activity such as business confidence are running rampant, which supports our view that growth will accelerate to over 4% this year. The post-earthquake rebuild in Canterbury and rising house prices are now being joined by a sharp lift in export incomes, which is expected to flow through to additional spending and investment.

With the economy moving closer to full capacity, home-grown inflation pressures are on the rise again. While annual inflation is still at a low 1.6% at present, it has exceeded the RBNZ's forecasts in the last two quarters. Firms' pricing intentions and inflation expectations have also picked up, and are now higher than what would be consistent with the 2% midpoint of the RBNZ's inflation target range – a point that carries additional weight in the RBNZ's current Policy Targets Agreement.

The New Zealand dollar is a little stronger than was assumed in the December *MPS*, though this can easily be attributed to positive economic developments since then. On top of stronger domestic activity, strong overseas demand has kept New Zealand's export commodity prices aloft for longer than expected.

The one notable negative in the last few months is the housing market. In December the RBNZ forecast that house price inflation would still be running at a 10% annualised pace in the early part of this year, even with its restrictions on high loan-to-value ratio mortgage lending in place. We felt at the time that this view was too bullish, and recent data confirms that this will need to be revised down in the near term.

All together, we estimate that developments since December are worth an additional 20-30 basis points on the RBNZ's interest rate projections over the next two years. That in turn suggests around 125bps of OCR hikes over this year, or five 25bp increments spread over the seven remaining review dates. We don't think this would push the RBNZ towards a 50bp move at any stage, but it doesn't leave much room for drawing out the process.

It's worth noting that the March *MPS* is likely to include an additional year of projections (out to March 2017), which will give a clearer idea of where the RBNZ sees the peak in this cycle. We expect the updated projections to show the 90-day bank bill rate peaking just above 5%, higher than the 4.5% that the RBNZ judges to be its long-run 'neutral' level. We share the RBNZ's view that the inflation pressures generated by the Canterbury rebuild will require short-term rates to stay above neutral for a period of time.

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