Westpac Institutional Bank

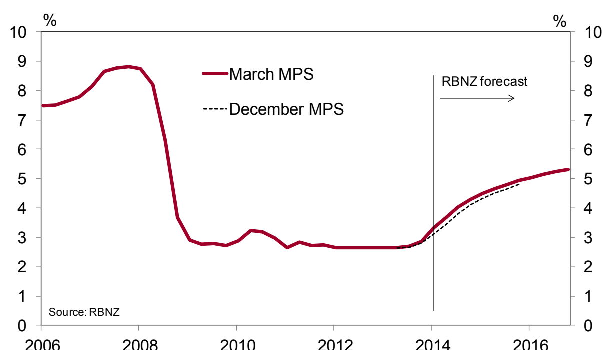
13 March 2014

The first of many

March 2014 MPS Review: OCR increased to 2.75%

- The Reserve Bank today increased to OCR from 2.50% to 2.75% as widely expected, and strongly indicated more to come over the course of this year.
- The economy is already seen as running above its non-inflationary capacity, and is expected to accelerate further this year.
- In this environment, inflation is expected to rise earlier than the RBNZ previously thought.
- The RBNZ is aware of the sensitivities around monetary policy and was careful to portray today's move as a reduction of stimulus, aimed at ensuring that the economy's upswing remains at a sustainable pace.
- Nevertheless, the case for leaning against home-grown inflation pressures is now well-established, and further OCR hikes are more likely to be front-loaded.
- Our forecast remains for further 25bp hikes at the next OCR reviews in April, June and July, then a pause to assess their impact, before resuming hikes at a more gradual pace from December.

90-day rate, RBNZ projections



As was widely expected, the Reserve Bank today delivered the first of what is likely to be an extended series of interest rate hikes, using today's *Monetary Policy Statement (MPS)* to elaborate on the case for removing monetary stimulus. With economic growth now running above trend, inflation is expected to return to the 2% midpoint of the target band in the near future, and the RBNZ will be well aware that allowing inflation to accelerate much beyond that point will only make its job harder over the longer term.

While the future path of interest rates is never pre-determined, the RBNZ was quite open that its central view implies another 100 basis points of OCR increases this year, most likely being front-loaded. That doesn't leave much wiggle room to debate the timing of those hikes, and supports our prior view that the OCR will be increased further at the next three reviews in April, June and July, with further hikes from December onward.

The RBNZ seems aware of the sensitivities around raising interest rates, framing it in terms of removing stimulus rather than a tightening of policy. Today's statement noted that "it is necessary to raise interest rates towards a level at which they are no longer adding to demand", and that "by increasing the OCR as needed... the Bank is seeking to ensure that the economic expansion can be sustained". While the monetary policy framework is shaping up as an election-year issue, we don't get a sense that this will affect the extent or timing of OCR hikes this year.

Before today's statement, financial markets weren't completely sold on the case for five OCR hikes this year, so wholesale interest rates and the New Zealand dollar rose slightly in response. The muted market response will give the RBNZ some comfort that it can indeed 'go it alone' on interest rate hikes without the risk of driving the currency ever-higher.

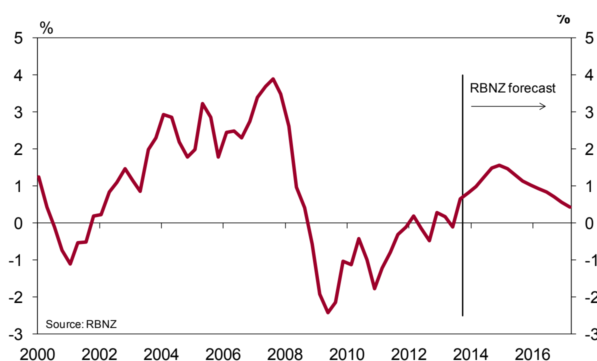
Details

The language of today's *MPS* was noticeably more assertive than even the previous RBNZ statement in January. The RBNZ noted that the economy's expansion is "becoming more

broad-based", that inflation pressures are not just "expected to increase" but are now "becoming apparent", and that "it is important that inflation expectations remain contained".

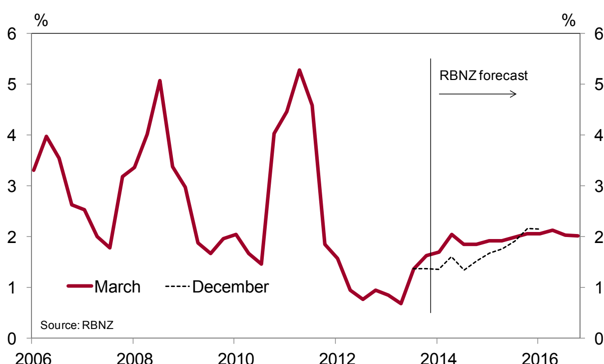
Compared to the December *MPS*, the RBNZ has lifted its GDP growth forecast from around 3% to 3.5% for this year. Part of the increase in the growth profile comes from the fact that the RBNZ has upped its assessment of the economy's potential growth over the next few years – the result of stronger than expected net migration, higher than expected labour force participation, and recent revisions to GDP showing that investment in capital equipment in recent year has been greater than thought. Even so, the RBNZ judges that the level of GDP is already running almost 1% above its non-inflationary potential, and the gap is expected to widen further as the economy expands and the Christchurch rebuild shifts into top gear.

RBNZ estimate of output gap



The RBNZ has also notably upped its inflation forecasts, particularly for this year – in part a necessary response to recent upside surprises on the CPI. Whereas the December *MPS* projected that annual inflation wouldn't reach the 2% midpoint of the RBNZ's target range until the end of 2015, it now expects inflation to hit that mark by the middle of this year, and to remain just a touch below it over the following year. Given that the RBNZ's current Policy Targets Agreement puts an increased emphasis on that 2% midpoint, and that surveyed expectations of inflation have been tending to drift up and away from the 2% mark, the RBNZ has little room for complacency.

CPI inflation, RBNZ forecasts



The RBNZ's projected path for the 90-day interest rate was 20-30 basis points higher compared to the December *MPS*, which was more or less as expected and fairly reflects the stronger tone of the economic data over the last three months. What may have come as a surprise to markets is that, even with an additional year of projections this time, the RBNZ still fell short of signalling where it sees the peak in the tightening cycle – the 90-day rate was projected to be at 5.3%, and still rising, by early 2017. While that's not markedly out of line with our own view, it serves as a wake-up call to the market that the OCR will likely need to move above its 'neutral' level for a period of time.

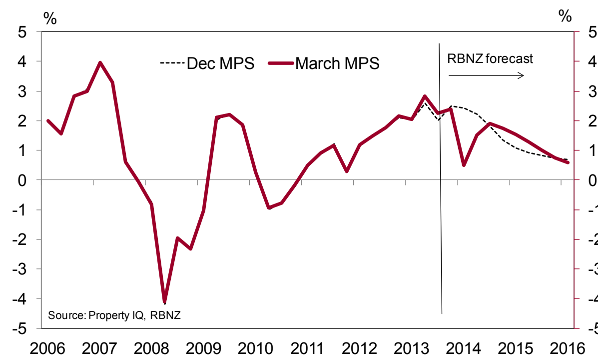
The *MPS* did not dwell significantly on the risks around the RBNZ's central view, though there were two points worth noting. The first is that the New Zealand dollar has risen further since the December *MPS* projections; the RBNZ continued to describe it as a headwind to the tradables sector, and unsustainable over the long term. However, it was only weakly linked into the expected future path for interest rates. The statement noted that:

"The speed and extent to which the OCR will be raised will depend on economic data and our continuing assessment of emerging inflationary pressures."

A further sharp rise in the exchange rate would certainly change that assessment of inflationary pressures, but that's the full extent to which the high NZ dollar might alter the RBNZ's plans. And on that point, it's worth noting that despite a higher expected track for the NZ dollar trade-weighted index, the RBNZ has actually lifted its forecast of tradables inflation compared to the December *MPS*.

The second point is that the housing market has cooled substantially in recent months, since the restrictions on high loan-to-value mortgage lending came into force (though the RBNZ also took up the point we've been making that higher mortgage rates have also been working against the housing market in this time). The RBNZ's assessment is that it's too soon to tell whether the impact of the LVR restrictions has been more severe than anticipated, but it may be that the effects are more front-loaded than assumed.

Quarterly house price inflation



Hence, the RBNZ is now expecting house price growth to slow sharply over the early part of this year, but to accelerate again over the second half of the year as strong net inward migration drives housing demand. This is one area where we regard the RBNZ as being too bullish. We've long emphasised the importance of mortgage rates for house prices, and with interest rates projected to steadily rise, we expect slower house price inflation in 2015 compared to the RBNZ forecast.

The next move

The RBNZ stopped short of explicitly signalling a follow-up move at the 24 April OCR review – though by the same token, it gave no indication that it is looking to pause and assess the impact of today's move. And with the RBNZ's central projections pointing to a further 100 basis points of OCR hikes over the course of this year, the timing of the next move is perhaps more a tactical issue than a substantive one.

Our case for a follow-up hike in April is as follows. First, the RBNZ's 90-day rate projection suggests that rate hikes are likely to be front-loaded, and while there is some intentional ambiguity in these projections, they are far more consistent with an April rate hike than a June one. Second, the prospect of another 100 basis points of hikes this year implies four 25bp moves over six remaining review dates – so the RBNZ has given itself scope to pause on only two occasions this year. It's not obvious why the RBNZ would want or need to exercise that option straight away.

Market reaction

Financial markets were thoroughly prepared for today's OCR hike, although market pricing was sitting somewhere between four and five hikes over the course of this year. Hence, there was a modest rise in swap rates and the NZ dollar following the statement.

The muted market reaction gives crucial support for our view that the OCR will indeed be increased five times this year. While the prospect of a tightening cycle was already factored into market prices, there was a risk – however remote – that the NZ dollar could have shot higher once the start of the tightening cycle was confirmed. Had it done so, future hikes may have been scuttled. In the event, the currency has remained well behaved, and our expectation for the OCR to reach 3.75% by the end of this year remains intact.

RBNZ media release

The Reserve Bank today increased the OCR by 25 basis points to 2.75 percent.

New Zealand's economic expansion has considerable momentum, and growth is becoming more broad-based. GDP is estimated to have grown by 3.3 percent in the year to March. Growth is gradually increasing in New Zealand's trading partners. However, improvements in major economies have required exceptional support from monetary policy. Global financial conditions continue to be very accommodating, with bond yields in most advanced countries low and equity markets performing strongly.

Prices for New Zealand's export commodities remain very high, and especially for dairy. Domestically, the extended period of low interest rates and continued strong growth in construction sector activity have supported recovery. A rapid increase in net immigration over the past 18 months has also boosted housing and consumer demand. Confidence is very high among consumers and businesses, and hiring and investment intentions continue to increase.

Growth in demand has been absorbing spare capacity, and inflationary pressures are becoming apparent, especially in the non-tradables sector. In the tradables sector, weak import price inflation and the high exchange rate have held down inflation. The high exchange rate remains a headwind to the tradables sector. The Bank does not believe the current level of the exchange rate is sustainable in the long run.

There has been some moderation in the housing market. Restrictions on high loan-to-value ratio mortgage lending are starting to ease pressure, and rising interest rates will have a further moderating influence. However, the increase in net immigration flows will remain an offsetting influence.

While headline inflation has been moderate, inflationary pressures are increasing and are expected to continue doing so over the next two years. In this environment it is important that inflation expectations remain contained. To achieve this it is necessary to raise interest rates towards a level at which they are no longer adding to demand. The Bank is commencing this adjustment today. The speed and extent to which the OCR will be raised will depend on economic data and our continuing assessment of emerging inflationary pressures.

By increasing the OCR as needed to keep future average inflation near the 2 percent target mid-point, the Bank is seeking to ensure that the economic expansion can be sustained.

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