

Kicking the can down the road

September 2014 MPS preview: OCR to remain 3.5%

- The OCR will be left unchanged at 3.5% next week.
- Given the looming election, the RBNZ may opt for a low profile in its communications. Now is not the time to put a stake in the ground.
- We expect the RBNZ to signal that the OCR will remain on “pause”, thus ruling out an October hike.
- But the RBNZ will also reiterate its overarching expectation that the OCR will rise substantially over the coming years.
- Markets may be surprised when the forecast of 90-day interest rates doesn't move much. We expect interest rates to rise a little on the day.
- The New Zealand dollar reaction to the MPS is more uncertain, depending on the RBNZ's choice of words regarding the exchange rate.
- We expect the next OCR hike will occur in January 2015.

The Reserve Bank announced a “pause” in its programme of OCR hikes in its last monetary policy dialogue, the July OCR Review. That renders next week's September *Monetary Policy Statement* a dead rubber – the OCR will be left unchanged at 3.5%, end of story.

But there is still plenty of interest in the communique that will accompany the on-hold OCR decision. Judging by current market prices, financial markets are convinced that the Reserve Bank is about to back down on its earlier forecast that the OCR will rise substantially over the coming couple of years.

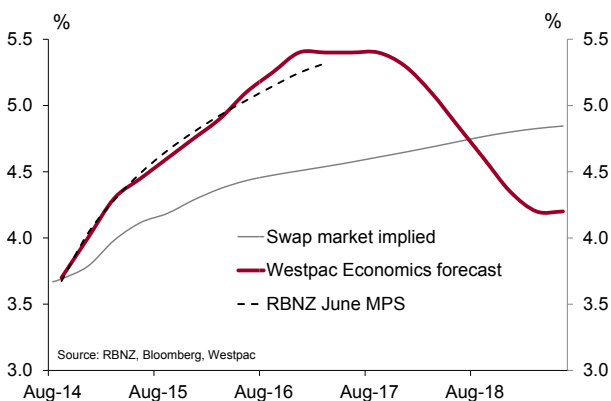
We are not so sure that the RBNZ has cause to acquiesce. As we explain below, recent economic developments are actually quite ambiguous. Economic growth, inflation and dairy prices are all lower than expected. But net immigration has snowballed unexpectedly, fixed mortgage rates are falling, and the exchange rate has dropped. It is not entirely clear which of these developments dominates so far as the medium-term inflation outlook is concerned.

That said, now is not the time for the RBNZ to push the point. We doubt that the RBNZ will go out of its way to “correct” errant market pricing, the way it did in June. The *Monetary Policy Statement* falls only nine days before a general election – any forecast issued now could well be rendered obsolete by the election outcome. At this juncture firm commitments and bold forecasts are best avoided in favour of a softly-softly approach.

The best course available to the RBNZ is to “kick the can down the road” until the election has passed. The RBNZ can tackle the market head-on in December, if the data still warrants.

We expect the RBNZ's press release will repeat the July comment that it “is prudent that there now be a period of assessment....” This would effectively rule out a October hike, and would cast doubt upon a December hike. But the statement will probably also reiterate the broad themes that the RBNZ has promulgated all year, including its expectation

90-day rate forecasts: market, RBNZ, and Westpac



that the OCR will rise to a more normal level over the years ahead. The overall tone of the press release may fall somewhere between the June press release (which sounded very keen to raise the OCR) and the July press release (which was more contrite).

The RBNZ's 90-day interest rate forecast

Convention dictates that the RBNZ must issue a forecast of 90-day interest rates, along with a comparison to the forecast from the June MPS. Markets seem to expect that the new forecast will be much lower than the old one. We are not so sure. We do expect that the new forecast will feature lower 90-day rates in 2014, consistent with the OCR remaining at 3.5% for a while yet. But we suspect that the 90-day interest rate forecast for 2016 will be little changed from the June MPS – or at most, 10 to 20 basis points lower.

To understand where the RBNZ might land on this, it is useful to consider recent economic developments from the RBNZ's point of view. First the negatives:

- The New Zealand economy has lost momentum – quarterly GDP growth has dropped from above 1% to about 0.7%.
- Global auction prices for dairy products have continued to plunge in recent weeks. The June *Monetary Policy Statement* contained an alternative scenario in which export prices fell 4% over and above the substantial fall already factored into the main forecast. Recent experience has not been quite that severe, but it isn't far off. In that alternative scenario the RBNZ indicated that the pace of OCR hikes would be attenuated by 20 basis points over two years.
- The near-term outlook for inflation has moderated. June quarter inflation data was in line with expectations, but the detail revealed that underlying inflation was subdued while headline inflation was propped up by transitory factors. In addition, data last week showed that food prices unexpectedly dropped in July. And changes to the Government's plans mean that next year's ACC levy reductions will knock more off inflation than previously allowed for. All of this has caused us to lower our forecast for inflation in 2015 to just 2.0%.
- Surveys of inflation expectations have moderated slightly in recent months.
- The housing market is in recovery mode after the pasting it took earlier this year. However, the pace of recovery has been a little more modest than the RBNZ anticipated (house prices are presently rising at approximately 2% per quarter, compared to the RBNZ's forecast of 2.5% per quarter).

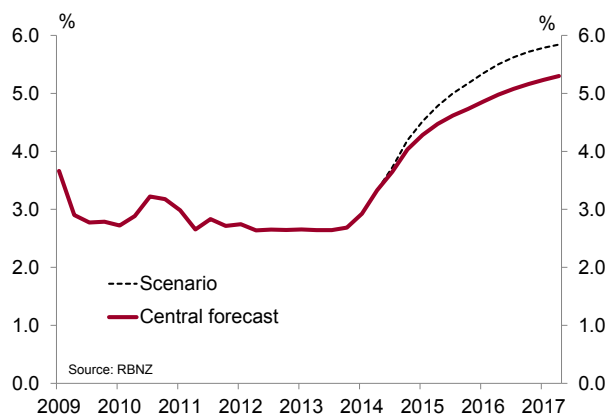
Impressive as this list of negatives is, there have also been important developments on the "positive" side:

- On a trade-weighted basis the exchange rate has fallen almost 4% from its peak, and now stands a little lower than the RBNZ's forecast from the June MPS. Regular readers will know that the exchange rate is always a crucial part of deliberations at the RBNZ.

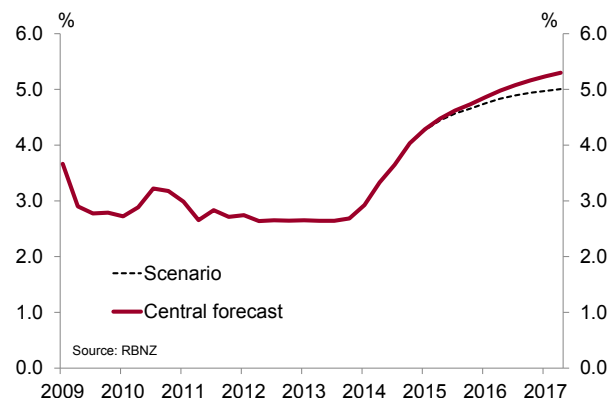
- Net immigration continues to surge, and on our forecasts will reach an all-time high of 50,000 people per annum early next year. The most recent surprise has been extra arrivals coming into the country, rather than fewer departures (inflation is most sensitive to arrivals). The June MPS contained an alternative scenario in which net immigration rose by an extra 4,000 people per quarter. The recent surprise has been almost, but not quite, of that magnitude. In the scenario, the OCR had to rise by an extra 55 basis points over two years.
- Fixed mortgage rates have fallen recently, and mortgage borrowers are taking the opportunity to fix their interest rates (a wise move, in our opinion). The average advertised two-year mortgage rate is now nine basis points lower than it was on the eve of the first OCR hike. Of course, lower fixed mortgage rates risks reigniting the housing market.

Our assessment is that the negatives and positives in this list roughly offset one another. The outlook for medium-term inflation is lower than it was back in June, but is higher than it was in July. There is, of course, scope for the RBNZ to come to a different judgement than we have. But it seems extremely unlikely that the RBNZ would come close to the view encapsulated by current interest rate market pricing.

90-day interest rates under stronger net immigration scenario, June MPS



90-day interest rates under weaker export price scenario, June MPS



Market reaction

A *Monetary Policy Statement* along the lines we expect would surprise financial markets. However, if the RBNZ does take a softly-softly approach to its rhetoric, then the scope for interest rates to rise on the day will be limited – especially with an uncertain election looming the near future. We think the most likely market reaction is a small rise in swap rates on the day.

The likely exchange rate reaction is more uncertain. Normally, the exchange rate would move in the same direction as interest rates, and a good argument can be mounted to suggest that the currency will rise on this occasion also. But there is a good chance that the RBNZ will use code-words for currency intervention in the press release, such as “unjustified” (even though the exchange rate has fallen, the RBNZ will still regard it as too high). Depending on the intensity of such language the currency reaction could differ to the interest rate reaction, up to and including the possibility of the exchange rate falling on the day.

Dominick Stephens

Chief Economist

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Anne Boniface, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

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