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September *MPS* Preview: OCR to be held at 3.00%

- **Uncertain economic conditions, along with the potential impact on confidence from the SCF failure and the Canterbury earthquakes, mean that the RBNZ is likely to take a breather in the tightening cycle next week.**
- **However, the RBNZ will still be projecting a much higher peak in the OCR than what the market is currently pricing.**

In recent weeks we've come around to the view that the RBNZ will leave the OCR on hold at next Thursday's review. The economic data has given mixed messages about the pace of the domestic recovery, and the global picture has become, in the words of the Fed chairman, "unusually uncertain". The failure of South Canterbury Finance and the severe earthquake in the Canterbury region go further towards making a pause a tactful move, but the die was probably cast even before those events.

That said, we expect this to be only a short break within the RBNZ's long-stated plan to return rates to more normal levels as the economy recovers. The June *Monetary Policy Statement* indicated that this could mean an OCR as high as 6% by the end of 2012 – from a starting point of 2.5%, that's a lot more tightening than the RBNZ has ever had to signal in any previous cycle.

That message hasn't been prominent lately. The July OCR review noted that "the pace and extent of further OCR increases is likely to be more moderate", which was understandable in light of recent information. And a speech by Governor Bollard, titled "Keeping inflation anchored during economy recovery", revealed a relaxed attitude towards the upcoming policy-induced inflation spike, and missed what seemed like a clear opportunity to remind the market that further tightening was on the way.

But it would be a mistake to assume that the RBNZ has gone soft on the need to return rates to normal, on the basis of these statements. Media releases and speeches rarely touch on the RBNZ's longer-term policy intentions; for that, you have to go to the projections and discussion in the *MPS*.

Key considerations

The likely changes to the RBNZ's forecasts are from a range of sources. First, the global economy is looking more precarious than it did earlier this year. It's not all bad news, with Q2 growth turning out much better than expected in Australia, Germany, the UK and Southeast Asia. But there are clear signs of, at the least, a mid-cycle slowdown in the US, Japan and China, and Europe is still far from resolving its sovereign debt concerns.

The local economy is coming from a lower starting point than thought: GDP grew by 0.6% in the March quarter, compared to the RBNZ's estimate of 0.8%. On top of this, the RBNZ assumed 1.1% growth in the June quarter, which at the time was much higher than market forecasts, and even now it's not clear that that figure is achievable. We've seen strong growth in retail sales, wholesale trade and construction, but manufacturing sales were surprisingly weak, and drought conditions earlier in the year thumped dairy output for the quarter.

Of the major data releases since June, the most disappointing was the rise in the unemployment rate from 6.0% to 6.8%. But that needs to be put in the context of widespread scepticism about the previous quarter's plunge, from 7.1% to 6.0%. The RBNZ is aware of the ongoing issues with the household labour force survey, and we suspect it won't have put much stock in either movement.

Inflation and – more crucially for the RBNZ – inflation expectations have been well-behaved to date, in the face of an impending price spike driven by an increase in GST, the ETS, higher ACC charges, and tobacco excise duties. Surveyed expectations of inflation two years ahead actually fell, from 2.8% to 2.6%. The RBNZ will take considerable comfort from this, though we suspect the real test of attitudes to inflation will come next year, once the inflation peak actually occurs.

Financial conditions have been mixed since the June *MPS*. The exchange rate is tracking higher than the RBNZ's projections, but market interest rates have fallen substantially. The mortgage rate curve has flattened so far that it's feasible again for borrowers to 'escape' the impact of any further OCR hikes by switching into fixed-term rates.

For further information, questions or comments contact Brendan O'Donovan, telephone (04) 470 8250, email brendan_odonovan@westpac.co.nz

The collapse of SCF and the Canterbury earthquakes both make a case for the RBNZ to sit out next week's review, at a time when economic confidence may be fragile. Beyond this, both events are best dealt with through the targeted measures that are already being put in place, not with a blunt tool like interest rates. The RBNZ is not likely to have incorporated any earthquake effects in their economic projections (which are usually finalised two weeks before release) but it will certainly be discussed in the policy assessment.

Projections and market implications

Our assessment is that developments since the June *MPS* will have knocked about half a percent off the RBNZ's interest rate projections. That's a relatively large change in the space of three months – but a peak OCR of around 5.25% is still a far cry from the 4% peak that interest rate markets are currently pricing.

As a result, we expect a statement along these lines: "Given recent developments, we believe it is appropriate to leave current policy settings in place for the time being. However, further removal of stimulus will be necessary if the economy evolves as projected." That's not strongly-worded enough to suggest a hike at the next OCR review in October, but it would fit with a resumption of tightening in the December *MPS*, barring any further negative surprises.

Market pricing of OCR hikes has been scaled back dramatically in the last couple of months, with traders fixated on overseas developments. That said, some of the more recent US figures have been better than expected, which could leave the market more receptive to a strongly-worded statement from the RBNZ. Pricing for a 60% chance of a December hike is unlikely to be disturbed by next week's statement; longer-term wholesale rates may continue their recent bounce.

Brendan O'Donovan, Chief Economist, Ph: (64–4) 470 8250
Michael Gordon, Markets Economist, Ph: (64–4) 381 1412