Westpac Institutional Bank

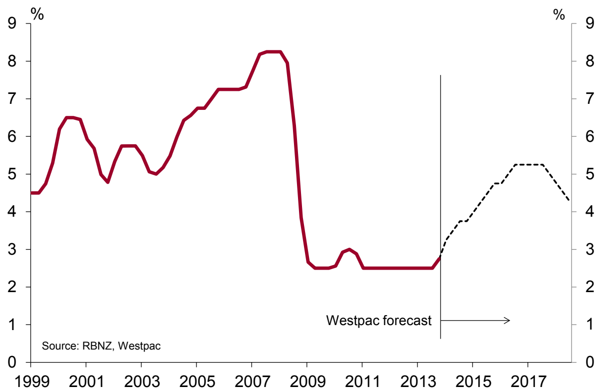
5 June 2014

Herding cats

June 2014 MPS preview: OCR to rise 25bp to 3.25%

- We expect the RBNZ to hike the OCR by 25 basis points next week, and to reiterate its plans to follow up with further OCR hikes this year and next.
- The RBNZ may sound a touch less adamant about the pace and extent of hikes than it was in the March *MPS* – but only a touch.
- Markets are expecting a more radical downgrade to the RBNZ's planned hiking cycle, and may be quite surprised by this *MPS*.
- If we are correct, swap rates and the exchange rate will rise on the day.

90-day rate projections



At next week's *Monetary Policy Statement* we expect the RBNZ to reiterate its broad intention to hike the OCR substantially over the next two years. Compared to the March *MPS*, the RBNZ might sound a touch less worried about inflation, and the forecast of 90-day interest rates might be downgraded by 10 or 20 basis points. But this will be detail around the edges – the main point of the document will be to communicate that further hikes are coming.

Financial markets seem to be awaiting a much more radical change of tone. We suspect that one of the RBNZ's key aims next week will be to bring errant financial market pricing back into line with its own thinking – an exercise that can be like herding cats. If we are correct, next week's *MPS* could produce an increase in swap rates and the exchange rate.

The story so far

When it kicked off its OCR hiking cycle in March this year, the Reserve Bank was very explicit about its plans for the future. The March *Monetary Policy Statement* seemed explicitly crafted to convey one message – that the OCR was heading higher. The RBNZ said it expected to deliver around two hundred basis points of OCR hikes over the course of two years. And the RBNZ's forecast of 90-day interest rates showed that it was expecting to deliver four consecutive OCR hikes (March, April, June, and July) followed by one additional hike later in 2014.

But the RBNZ always reserves the right to adapt its plans in response to evolving data. In the weeks following the March *Monetary Policy Statement*, inflation turned out weaker than expected, the exchange rate rose, and dairy export prices fell. The RBNZ seemed to modify its thinking in response. In the April OCR Review the RBNZ singled out the exchange rate as a factor that could affect the timing and extent of future OCR hikes, and it sounded a little less adamant about the extent of hikes. However, the RBNZ did still deliver a hike in April, and it did nothing to detract from the idea that yet another hike would come in June.

Since April, markets appear to have become even more sceptical about the extent of the RBNZ's OCR hiking cycle. Interest rates have fallen to the point where swap market pricing indicates an expectation that the OCR will be 4.0% at the end of 2015. By contrast, the RBNZ's forecasts back in March implied an OCR of 4.5% at that point.

This drop in market interest rates will be worrying for the Reserve Bank, because it is prompting banks to reduce fixed mortgage rates – the average two-year fixed mortgage rate advertised by the four main banks has fallen 34 basis points in two months. Lower mortgage rates could reignite the housing market.

What is more, this market-driven drop in interest rates is inconsistent with recent developments. On balance, New Zealand economic developments since April have tended to support the case for further OCR hikes. In particular:

- The exchange rate has fallen in recent weeks, and on a trade-weighted basis is barely higher than it was at the time the March *MPS* was published.
- The Government has issued a surprisingly expansionary budget, which will further the need for OCR hikes.
- Net migration has continued to boom, and has exceeded the RBNZ's expectations by a very wide margin. We cannot overstate the importance of booming net migration in the RBNZ's thinking on the housing market and inflation pressures.
- Momentum in the economy has remained strong.

True, there have also been a couple of negative developments. The unemployment rate lingered at a higher level than expected, although this was due to strong growth in the labour force rather than flagging employment. And dairy export prices have fallen a bit further since the April OCR Review. Both are important, but they probably only constitute partial offsets to the lower exchange rate, expansionary budget, booming migration, and falling mortgage rates so far as the RBNZ's assessment of inflation pressures is concerned.

In our assessment the RBNZ will deliver an OCR hike next week, and will firmly reiterate the case of OCR hikes in the accompanying *Monetary Policy Statement*. The RBNZ's 90-day interest rate forecast may be a shade lower than the forecast it issued back March – but only a shade. Of course, the RBNZ will cover off the various developments we have discussed above, and the resulting tone might be a touch less adamant about OCR hikes than the tone struck in the March missive. However, the overall tone could be slightly more hawkish than the April OCR Review.

The challenge for the RBNZ will be to deliver this modest change to the outlook while still prodding errant financial markets into lifting two and three year swap rates. The right balance could be achieved by signalling that, from here, the OCR hiking program will proceed at a pace of 25 basis points per quarter. That would allow the RBNZ to skip the July OCR Review while still leaving no doubt about its intention to hike twice more before the year is out. (We expect those hikes to come in September and December).

If we are correct, next week's *Monetary Policy Statement* could produce quite a reaction on financial markets, with swap rates and the exchange rate rising.

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