

Amber light

July 28 OCR preview: RBNZ on hold at 2.50%

- **We expect the Reserve Bank to leave the OCR unchanged at 2.50% and downplay the case for near-term rate hikes.**
- **Stronger than expected GDP and inflation will be balanced against a much higher exchange rate and an uncomfortable global outlook.**
- **That said, an extended period of tightening is certainly on the way; now is the time for borrowers to fix.**

Summary

We expect the Reserve Bank to leave the cash rate unchanged at next Thursday's OCR review, and to maintain its signal for a gradual tightening over the next couple of years. We expect the RBNZ's statement will broadly reaffirm the December start date for hikes, as laid out in the June *Monetary Policy Statement*. That could come as a surprise to markets, which have moved to price in earlier hikes. Markets are responding to news of stronger growth and inflation, but there are equally important offsets in the sharp rise of the New Zealand dollar and signs of slower growth among our trading partners.

Details

Today's economic environment seems a world away from the one that prompted the RBNZ to cut the cash rate to 2.50% in March. In the wake of the devastating Christchurch earthquake on 22 February, the 50 basis point cut was meant to soften the direct impact on the Canterbury region, and to head off a blow to confidence that could see the effects spread through the wider economy.

It's now clear that this 'insurance policy' is no longer required, and with the benefit of hindsight was probably more than was needed. Not only has activity held up remarkably well in the face of the February earthquake, but with revisions to the recent GDP history we now know that the economy was running stronger than realised even before the quake struck. Monday's higher-than-expected inflation figures seem to have been the final straw for financial markets, which have swung from pricing at most one 25bp hike before year-end to a 70% chance of a hike by September.

On their own, domestic conditions make the case for reversing the 'insurance' cut sooner rather than later. But many other things have changed since March as well: the exchange rate is a lot stronger, the global environment looks more perilous, and commodity prices are softening. These factors can't be treated in isolation.

Some of the New Zealand dollar's recent strength can be pinned on the US dollar's dreary performance, but the latest run-up is clearly NZ-specific. Point-to-point, the trade-weighted index is 5% higher today than it was at the June *Monetary Policy Statement*, and 13% higher since the March rate cut. The RBNZ may not regard all of this move as enduring, but it will still carry a significant weight in the RBNZ's thinking.

The June *MPS* struck a notably more tolerant line on NZ dollar strength – but that was only to the extent that it was backed by higher export prices. There's been nothing new on that front to support the latest run-up in the currency: world prices for our commodity exports have flattened out in the last few months, and dairy product prices at auction have fallen 20% since March.

The other factor is the gathering clouds around the global economy. Ironically, the June *MPS* took a much more upbeat stance on the world just as things were starting to turn softer; since then we've seen further signs of slowing not only in the debt-plagued US and European economies, but in our two most important trading partners Australia and China. Given that the European and US sovereign debt crises are both approaching crucial milestones, there's also a case for waiting to see how they pan out before forging ahead with a plan to hike rates.

Statement

We expect that next week's media release will reiterate that the outlook for the New Zealand economy is improving, but will bring exchange rate and global growth concerns back into prominence.

The fact that the economy has held up well in the face of the Canterbury earthquakes is not news to the RBNZ, although the

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pace of recovery has been stronger than expected. Similarly, the spike in annual inflation above 5% is not in itself a concern; the RBNZ can still argue that measures of capacity utilisation and core inflation (excluding the likes of the GST hike) remain modest, though it will be keeping a wary eye on inflation expectations. The more significant new development is the rise in the exchange rate.

Our pick for the final 'bias' paragraph retains most of what was in the June media release, but with a more forceful statement against near-term rate hikes:

“As GDP growth picks up, underlying inflation is expected to rise. A gradual increase in the OCR over the next two years will be required to offset this, such that CPI inflation tracks close to the midpoint of the target band over the latter part of the projection. However, the high level of the New Zealand dollar will play a significant role in dampening inflationary pressures, reducing the need for hikes for the time being.”

Such a statement would be more consistent with our call for a December OCR hike than with the Sep/Oct start that financial markets are now pricing in. That in turn would take some of the immediate edge off the recent sharp rise in market rates (the two-year swap rate has risen 30bps since the GDP figures). But beyond that, term interest rates are set to crawl higher in coming months as the tightening cycle draws nearer. For those borrowers who have been waiting for the right time to fix, the market's capitulation in the last week is as definitive a signal as you're going to get.

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