Saying a lot with a little

Jan 26 OCR review: RBNZ on hold at 2.50% until later in the year

- **The Reserve Bank left the cash rate unchanged at 2.50% and implicitly signalled a longer delay to interest rate hikes.**
- **The recent moderation in inflation has reassured the RBNZ that it can wait and watch how Europe's debt woes and Canterbury's post-quake recovery evolve.**
- **We continue to expect the next OCR move to be a 25bp hike in September.**

Summary

The Reserve Bank has implicitly pushed out the expected timing of rate hikes beyond the previously indicated June start date, but without getting too specific in today's short media release. With inflation well-contained at the moment, the RBNZ has room to wait for some of the downside risks to growth to be resolved. This was broadly the message that the market was expecting from the central bank, and fits with our call for the next OCR move to be a 25bp hike in September.

Details

As we expected, the RBNZ signalled a later start to interest rate hikes, without getting specific about the timing in today's brief statement. The key change was a small but purposeful omission from the final sentence: while the December media release noted that it remained prudent "for now" to keep the OCR on hold, those two words were absent this time. That removes the sense of impending hikes that was conveyed by the December *Monetary Policy Statement,* which projected a gradual rise on the OCR from around June this year.

The crucial development for the RBNZ is that inflation has proven to be better contained than expected. With the GST hike finally dropping out of the calculation, annual inflation fell to 1.8% in the December quarter, while the RBNZ's suite of core inflation measures sat slightly either side of 2% – all very comfortably within the target range of 1-3% over the medium term. It's notable that the RBNZ described the easing in inflation pressures as "reassuring" rather than worrying – the softer than expected outturns in the second half of last year largely served to balance out the sharp upside surprises in the first half.

With the risk of an inflation breakout off the table for the near term, the RBNZ is now free to wait for more clarity on global conditions and the pace of recovery activity in Canterbury. On the first matter, today's statement was actually more positive, noting that sentiment and market liquidity have improved slightly, particularly in Europe. The warning that tight credit conditions overseas "will likely pressure funding costs for New Zealand banks over the coming year" is a longstanding one, and if anything was a bit less definitive than in December.

The rest of the statement saw a range of tweaks around the margins. The extended boost to demand created by repairs and reconstruction in Canterbury still lies at the heart of the case for higher interest rates, but it's unclear whether the latest swarm of aftershocks will have an impact on the timeline. The bounce in the New Zealand dollar since December was mentioned as a dampening factor. And the signs of recovery in consumer spending and the housing market, while described as "limited", made an appearance in the statement for the first time.

Market implications

This was broadly the message that the market was expecting from the central bank: a later start to hikes, but not a marked change to the RBNZ's stance – far less dramatic than the US Federal Reserve's commitment to keep rates at zero until at least late 2014, which pushed the NZ dollar a cent higher this morning. Swap rates edged down by 3 basis points across the curve, though this also seems to be a reaction to the US decision. Market pricing for the OCR over the next year was untouched.

The RBNZ remains much more hawkish than market pricing, which implies no rate hikes until well into next year and a greater chance of a cut in the near term. This difference of opinion is likely to remain until we have some resolution on Europe's debt crisis and clear signs that reconstruction in Canterbury is boosting domestic demand. We suspect that the wait won't

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be as long as market pricing suggests – a gradual increase in the OCR starting from September still looks like a reasonable prospect.

RBNZ media release

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.

Reserve Bank Governor Alan Bollard said: "Since the time of the December Statement, financial market sentiment has improved slightly, with increased liquidity in European financial markets. However, the global economy remains fragile and risks to the outlook remain.

"World prices for New Zealand's export commodities have remained elevated but the recent appreciation of the New Zealand dollar is reducing exporters' returns. The European debt crisis has also increased the cost of international funding, which will likely pressure funding costs for New Zealand banks over the coming year.

"In the domestic economy we continue to see modest growth. Over recent months there have been signs of a limited recovery in household spending and the housing market. Further ahead, repairs and reconstruction in Canterbury will also provide a significant boost for an extended period, though there may be further delays resulting from the aftershocks.

"Reassuringly, inflation pressures have remained well contained. Inflation has declined and now sits below 2 percent.

"Given ongoing uncertainty around global conditions and the moderate pace of domestic demand, it remains prudent to keep the OCR on hold at 2.5 percent."

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