

Calm before the storm

January 28 OCR Preview: RBNZ on hold at 2.50%

- **The RBNZ will reiterate that they expect the tightening cycle to begin around the middle of this year.**
- **The timing of hikes is less significant than the extent of the tightening cycle. The economy has clearly moved into a recovery phase and short-term interest rates are a long way from normal.**

Maybe it's just the usual listlessness around the Christmas/New Year period, but there doesn't seem to be a great deal of anticipation around next Thursday's OCR review. Since the December *Monetary Policy Statement* the economic picture has generally panned out as the RBNZ expected, with no 'blockbuster' data that might warrant a change in view.

That suggests we should expect a fairly innocuous statement next week, with similar language to that used in December. But don't take that as a sign of complacency: the start of the OCR tightening cycle is drawing closer, and the RBNZ have already made it clear that once they have the confidence to begin, they will be doing a lot of work over the next couple of years to return policy to more normal settings.

Main developments

The New Zealand economy is starting pretty much from where the RBNZ expected in the December *MPS*. The 0.2% rise in September quarter GDP was just below their forecast of 0.4%, and June quarter activity was revised up slightly. There's an open question as to how much activity was dragged down by swine flu in Q3, though any lost ground is likely to have been made up in Q4.

Similarly, December quarter inflation was right in line with the RBNZ's forecast. Non-tradables inflation – the stubbornly persistent component through much of the last decade – was softer than they expected, with a gain of just 0.1%. However, any cheer on this front may be dampened by the fact that housing construction costs accelerated. Both we and the RBNZ expect a strong rebound in housing construction this year, and the idea that cost pressures are re-emerging this early in the game should be of some concern.

While the backward-looking data have panned out as expected, the indicators for near-term activity are looking substantially stronger than the RBNZ's assumptions. The December *Quarterly Survey of Business Opinion* provided further confirmation that New Zealand is in a recovery phase following recession. This survey is perhaps the best lead indicator for current-quarter GDP, and the details were consistent with our forecast of 1.1% growth in Q4, against the RBNZ's forecast of 0.6%.

The surprising element in the survey was the 2.5 percentage point jump in capacity utilisation, taking it back to above-average levels. The RBNZ were looking for spare capacity built up during the recession to dampen inflationary pressures, but this survey suggests that if anything domestic inflation pressure could soon be building again. However, the RBNZ may choose to play down this measure, given how volatile it has been over the last year.

Furthermore, one of the RBNZ's crucial assumptions – that the resurgent housing market would not feed through to consumer spending to the same degree as in the past – is not being borne out by the data. Private consumption rose by 0.7% in the September quarter, which we estimate was around 0.5% higher than the RBNZ had factored in. Retail spending continued to gather pace up to November, matching the recovery in confidence that consumers have expressed in recent surveys.

There is, however, one reason for caution: the housing market is finally showing signs of cooling as a result of higher long-term mortgage rates. Seasonally adjusted sales fell 15% in the last three months of 2009, and loan approvals have been extremely weak so far in January, pointing to another weak month for sales. Slower sales will help to take the heat out of prices, and in fact the REINZ's new stratified house price index fell in December after five months of strong gains. The RBNZ's December forecast of further housing strength in the early part of this year may be – for a change – on the optimistic side.

Statement

In December the RBNZ gave themselves more flexibility around the timing of rate hikes, noting that "conditions may support

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beginning to remove monetary stimulus around the middle of 2010”, and that this timing could change depending on how their projections evolved.

That flexibility is unlikely to be put to the test in next week’s statement. Recent data has generally been on expectations, although it has dealt to some of the uncertainties that the RBNZ highlighted in December – around the sustainability of the recovery, and around the consumer response to a resurgent housing market. As a result, we may see the RBNZ firm up the message that a tightening cycle is indeed coming, by noting that conditions ‘will support’ rather than ‘may support’ a tightening by mid-year.

We expect rate hikes to kick off in April, which would (just) qualify as “around the middle of 2010”. The RBNZ will probably want to give a clear signal before the first move, and that signal is more likely to come in the March *MPS* – with the benefit of another month or two of data and a full set of forecasts highlighting the strength of the recovery – than in a one-page statement next week.

While the RBNZ may see some flexibility in the timing of the first hike, they’ve made it clear that they have a lot of work to do once they begin. Interest rate settings need to be normalised over the next couple of years: activity is recovering, spare capacity is starting to be mopped up, and inflation has bottomed out at around the middle of the 1-3% target range. Even with the larger than usual gap between the OCR and market rates, short-term interest rates are a long way from what could be considered ‘normal’.

In December the RBNZ projected around 275 basis points of tightening by March 2012 (and probably more beyond that). Even with this decisive action, they expect annual inflation to rise to around 2.5% by 2011, which means that once again they will have less wiggle room to deal with upside surprises than with downside ones. Make no mistake – interest rates are going up this year, and perhaps quite rapidly. We are forecasting 25bp hikes at each review date from April, but we wouldn’t rule out some 50bp moves along the way if the RBNZ find themselves falling behind.

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