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Westpac InstitutionalBank

# Ready, set ...

## January 28 OCR Review: RBNZ on hold, but hikes are drawing near

- **The RBNZ left the cash rate unchanged at 2.50%, and reiterated that hikes were expected to begin around the middle of the year.**
- **With the recovery panning out as expected, the RBNZ is gradually gaining the confidence to begin a tightening cycle.**
- **We expect a series of 25bp rate hikes starting in April.**

There were no major surprises in today's OCR review, reflecting the fact that since the December *Monetary Policy Statement* the economy has panned out largely as the RBNZ projected. Even so, today's statement was no facsimile of the December one. It contained some subtle but important changes that firmed up the message that a tightening cycle is indeed on the way.

While the data has largely met expectations, that in itself has helped to resolve some of the uncertainties that the RBNZ noted in recent statements. In particular, they appear to have ditched their assumption that the resurgent housing market would not feed through to consumer spending to the same degree as in the past. The RBNZ noted that credit growth remains subdued, though even that may not be as reassuring as it seems: the latest figures show that housing debt grew by 3.3% in 2009, a much slower pace compared to previous years, but still likely to have outstripped income growth by a meaningful margin.

The key changes came in the last paragraph of the statement. In December the RBNZ stated that if the recovery continues as expected, "conditions may support beginning to remove monetary stimulus around the middle of 2010". This time they noted that "we would expect to begin removing policy stimulus around the middle of 2010". No apparent change in the timing, but the new wording gives a stronger sense of the likelihood of rate hikes by mid-year.

The other major difference was one of omission. In December the RBNZ noted that "recent tightening in financial conditions, driven by a higher exchange rate, increased long-term interest rates and a wider gap between the OCR and bank funding costs, reduces the need for more immediate action" – in other words, the market has done some of the initial work for them.

That line was absent from today's statement. At the risk of reading too much into something that wasn't there, this suggests to us that the leeway provided by this de facto tightening has largely run its course. That doesn't necessarily imply immediate action – if the RBNZ intended to hike at the next review in March, we think they would have made it crystal-clear in today's statement – but it does suggest that the RBNZ don't see a compelling case for holding off beyond the April review.

### Market implications

Swap rates have risen about 2 basis points today, reflecting the slightly more hawkish tone relative to December. Today's statement supports our view that the tightening cycle will kick off with a 25bp hike in April. The market was already in agreement with us prior to the statement, though pricing has since crept up to about 30bps for April, implying some chance of a 50bp move (or of a hike in March as well as April).

While there's been a lot of debate about the timing of the first rate hike, the extent of the tightening cycle probably hasn't received as much attention as it deserves. With the economy stabilising and the OCR starting out at an extremely low level, there is a lot of work to be done over the next year or two. We expect the RBNZ to favour 25bp hikes at each review, but the question of 'how fast' is partly a function of 'how far'. We wouldn't rule out some 50bp moves along the way if the RBNZ see themselves falling behind the pace.

We may get some guidance on this matter from Dr Bollard's speech to the Canterbury Employers' Chamber of Commerce tomorrow, titled "The crisis and monetary policy: what we learned and where we are going". This speech is an annual event, and generally focuses on high-level issues rather than current policy decisions. In our view, the big picture issues for monetary policy are around the degree of urgency to return rates to 'neutral' levels, and indeed where 'neutral' may lie in the post-credit crunch environment.

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**RBNZ media release**

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

Reserve Bank Governor Alan Bollard said: "The outlook for the New Zealand economy remains consistent with the projections underlying the December *Monetary Policy Statement.*

"Global activity continues to recover, helping push New Zealand's export commodity prices higher. Economic growth is most apparent in China, Australia, and emerging Asia. However, sustained growth throughout our trading partners is not assured, with many still facing impaired financial sectors and overall activity still reliant on policy support.

"Similarly, the New Zealand economy continues to recover. Policy stimulus and improving export earnings have seen a pickup in household spending. That said, households remain cautious, with credit growth subdued. Business spending remains weak.

"Annual CPI inflation is currently at the centre of the target band, and is expected to track comfortably within the band over the medium term.

"The economy is being assisted by both monetary and fiscal policy support. As growth becomes self sustaining, fiscal consolidation would help reduce the work that monetary policy might otherwise need to do.

"If the economy continues to recover in line with our December projections, we would expect to begin removing policy stimulus around the middle of 2010."

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