What the economists said

Thursday, March 13th 2014, mortgagerates.co.nz

Here we wrap up key points from the economists' comments on yesterday's OCR increase. Most of them comment on the changed interest rate track. BNZ says: "Wheeler has given the clear message that interest rates will simply keep on rising until such time that the economy and its participants behave."

ASB: Changes its predictions

We had been calling a March 2014 start to the tightening cycle for a long time. When we first made that call, it implied an earlier and more aggressive tightening cycle than the RBNZ was predicting. More recently, though, as the RBNZ has moved to a more hawkish stance, our forecast track had been predicting a more gradual cycle of hikes than the RBNZ. We are now changing our forecast to build in a follow-up hike in April, then subsequent hikes in July and December 2014.

We also expect a further four hikes over 2015, taking the OCR to a peak of 4.5% (previously we had anticipated three hikes this year and three more next year). That is still less aggressive than the RBNZ's forecasts, and also slightly less aggressive than market pricing over 2014. We still see several reasons why the tightening cycle should be fairly cautious or gradual, including the strong NZD and the potential for higher rates to have a swift, noticeable impact on the economy.

Westpac: RBNZ positively surprises the market

Of most interest for markets was the implied pace of rate hikes. To that end we received two clues. First, the final policy paragraph said: "While headline inflation has been moderate, inflationary pressures are increasing and are expected to continue doing so over the next two years. In this environment it is important that inflation expectations remain contained. To achieve this it is necessary to raise interest rates towards a level at which they are no longer adding to demand. The Bank is commencing this adjustment. The speed and extent to which the OCR will be raised will depend on economic data and our continuing assessment of emerging inflationary pressures. "

Second, and more explicitly, the RBNZ's 90-day interest forecast was raised by 23bp at the December 14 point, to imply an OCR by then of 3.75%. Prior to the MPS, the market had priced in 3.64% by December 2014. Thus, it was moderately and positively surprised.

Further, by extending the forecast to 2017, the RBNZ has also signalled its projected terminal rate – at least 5.00%. Earlier, the market had priced in a 4.50% terminal rate. This is a significant positive surprise.

BNZ: RBNZ in race to the top

The real point of interest was always going to be the strength, or otherwise, of the Bank's forward track. We had been looking for an aggressive stance and were not disappointed.

The Bank's published OCR track implies the cash rate will rise by a total of 125 basis points, to 3.75%, by year end. A further 75 basis points of hikes is anticipated through calendar 2015 and then another 50 in 2016. This leaves the cash rate no lower than 5% by the end of the Bank's forecast horizon (March 2017). Importantly, one

can't tell if this is the expected peak in the cycle as the rate track is still on a rising trend at the end of the forecast horizon.

The RBNZ's track is now little different to our own. The major difference is that we get to the top a little quicker than the Bank does, as we see a combination of stronger growth and higher inflation pressures, accompanied by a lower NZD TWI track, than the RBNZ does.

Our respective rate forecasts between now and March 2015 are almost identical. We have a quarterly average 90 day bank bill rate of 4.37% in the March quarter 2015. The RBNZ has 4.30%. In order for our forecast to come true the RBNZ must tighten by 25 basis points at every meeting bar two between now and next March. For what it's worth we have assumed that the Bank pauses in the meeting immediately prior to the election, September 11, and then again January 29, 2015.

That said, we are well aware the entire tightening cycle will be a watching game. We are all making bold assumptions as to how households and businesses respond to rising interest rates but it's been a long time since they faced this prognosis and the world is a very changed place post the GFC.

Accordingly, there is a very real risk that there is a much stronger negative demand reaction to rate increases than we are forecasting, necessitating a slower pace of rate increase. Be that as it may, there is an equal risk the domestic economy brushes aside the first set of hikes as interest costs simply move from really cheap to moderately cheap.

Immediately, we believe the central bank will push ahead with further 25 point hikes in both April and June. There are those talking of a stop/start cycle with a pause in April but we find this very hard to accept. Why would a central bank pull the trigger, say that it's got another 250 points to go, and then pause?

Sure, if the wheels fall off the world, if there is a knee-jerk reaction domestically to the first hike, or if the currency climbs another few percent this is plausible. But these things would have to happen first.

The market seems to understand this. At the time of writing the market had priced in 44 points of rate increases over the next two meetings. This seems sensible to us. It acknowledges two things: (i) that the probability of a 50 point hike is less than the probability of no-change; and (ii) that there is a residual risk, albeit small, that international or domestic conditions may go awry.

We should stress that we are highly supportive of the way that Governor Wheeler is handling this process. While we believe the Bank has been a little tardy in getting started we think that the current approach is commendable. If a central bank is going to commence a tightening cycle it has to give a clear message that it means business and will do whatever it takes to ensure the economy is managed into a non-inflationary state. Wheeler has given the clear message that interest rates will simply keep on rising until such time that the economy and its participants behave.

In raising the cash rate today he has also backed up his rhetoric with action leaving no-one in any doubt as to his intentions. In taking this stance, he has created a very upward sloping yield curve and is impacting expectations. Consequently, interest rates will not need to go as high as they might have with a softer stance.

This approach is in marked contrast to the approach of Wheeler's predecessor who, in the previous tightening cycle, was almost apologetic in his actions and gave investors and the general public alike the perception that

rate hikes would stop after each move higher. We believe this was one of the reasons why, ultimately, rates had to go as high as they then did.

The other point to reinforce, by comparison, is that Governor Wheeler is hell-bent on getting inflation to settle at 2.0% not the Bollard "1% to 3% on average over the medium term" objective. This means the stance on an up cycle will tend to be more aggressive.

JP Morgan: LVR restrictions front-loaded

Governor Wheeler made it clear that further policy action is not on a pre-set course, with the "speed and extent to which the OCR will be raised depending on economic data and the continuing assessment of emerging inflationary pressures". The burden is therefore on the data over the next few months to justify further policy action from the RBNZ.

The discussion on LVR restrictions were a little light-on relative to our expectations, though commentary that was provided suggests the Bank remains comfortable with how these measures are tracking. Indeed, "evidence to date is consistent with our projections that LVR restrictions would subtract between 1 and 4 percentage points from annual house price inflation over the first year of implementation". The Bank does acknowledge, however, that the impact from LVRs may be more front-loaded than initially expected, though a rebound in activity later this year cannot be ruled-out, especially considering the rapid increase in net immigration.

Once the hiking cycle becomes more mature, we feel an intriguing situation could develop where the Bank might see LVR restrictions as an inconvenient bolt-on that works through narrow channels and prevents them from making the full rates adjustment they would like to make to keep the consumer more broadly in check.

Flagging their removal at some point would allow a better balance of policy, through either another, broader macro-prudential tool (such as core funding ratio) or adding official policy tightening to the rate path assumed for 2015.

A lot is priced into the front end of the NZ curve, with markets anticipating a further 110bp in hikes over the next year. On our forecasts, the Bank will under-deliver somewhat relative to the market's expectations, with "only'' a further 75bp in rate hikes expected over the next twelve months. Our forecast for a more gradual policy normalisation stems from the ongoing caution exhibited in the consumer spending data of late (relative to other activity data) and signs that LVR restrictions are binding on the housing market, both of which argue against the RBNZ pursuing an aggressively front-loaded hiking cycle.

HSBC: Reserve Bank becomes more positive

Although the RBNZ's own interest rate forecasts suggest further hikes are likely in coming meetings. We expect the central bank to follow-up with an additional 75 bps of hikes in 2014, with the next move likely in April.

New Zealand's economy looks to be at the beginning of a boom and the RBNZ has responded to the strong pick-up in demand by raising the cash rate by 25 basis points to 2.75% - making it the first developed world central bank to raise rates in this cycle.

The RBNZ has responded to (a strengthening economy) by beginning to normalise interest rates from current low levels. The central bank's own interest rate projections imply around 125 basis points of hikes through 2014.

Since their December set of forecasts, the central bank is a bit more positive on the outlook for domestic activity - raising their forecasts for growth and inflation. At the same time, a stronger economy and greater inflation pressure has led to a stronger outlook for interest rates, with the 90-day rate profile raised around 10-20 basis points through the forecasts. By the end of 2015, the bank expects to raise interest rates by around 200 basis points - as it acts to offset the inflationary impact of a strengthening economy.