

RBNZ To Hold Steady at 7.5% For Now

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Triggering stop losses around 0.68, the NZD/USD slid to 0.6757 during Asian trading (on Thurs) after the RBNZ lifted rates by 25bps to 7.5%, but toned down the degree of hawkishness. Of significance, the central bank Gov Bollard said "further tightening may be required", easing down from "will be required" in his previous statement. However, the slight change in nuance proved of little surprise to us, given our expectations of just one 25bps hike to 7.5% this year, compared to markets pricing in some odds of rates at 7.75% over next 6mths prior to the March meeting. Markets are presently pricing in steady rates at 7.5% over next 1 year.

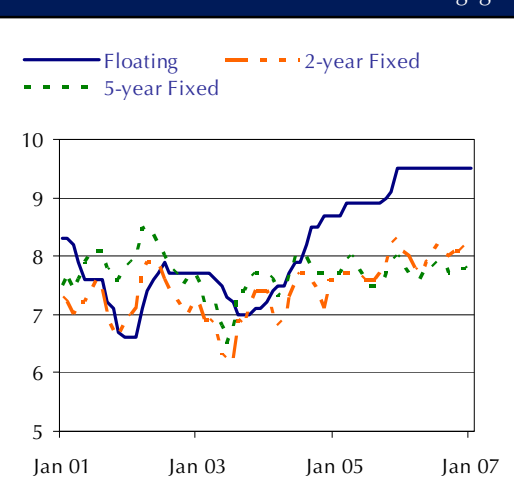
Key Highlights of RBNZ's Statement:

- Strengthening domestic demand, supported by a resurgence in the housing market and the expansionary fiscal policy are adding to the risks of re-emerging inflation pressure over the medium term. Concerns are towards **any pickup in momentum of housing and domestic demand, giving rise to a stronger cyclical upturn amid already very tight resource usage.**
- Short-term inflation outlook continues to ease. CPI is projected to be around the middle of the target band through 2007, benefiting from lower oil prices and the high exchange rate. Domestic CPI is also expected to moderate this year, helped by the impact of softer headline inflation on inflation expectations. Nonetheless, **over the medium term, domestic inflation is projected to remain at high levels, with significant upside risks.**
- The CB is considering **alternative measures** such as tightening of tax rules applying to housing investment and changes to bank capital requirements to help moderate the amplifying effect of credit on the housing cycle. However, interest rates (OCR) would remain as the primary instrument of monetary policy.
- Depending on the persistence of the current upturn, **further tightening may be required.** Essential for moderation in housing and domestic demand, in order to if we are to see a reduction in medium-term inflation pressures.

Our Take:

Pick-up in House Prices and Domestic Demand Posing Inflation Risks: Over recent months, housing inflation continued to persist over 10%. Impact of past rate hikes on the housing market has to some extent has been limited by households' preference for fixed rates loans (80% of the mortgage market). Amid intense competition among commercial banks, the cost of borrowing continued to remain attractive, with fixed rates persisting below floating rates. See below chart. In addition, private consumption has rebounded, with discretionary spending bolstered by the decline in energy prices and tight labour market. Trough in the economic cycle appears past, with real GDP seen accelerating 1.6%/y/y in Q4 vs 1.4%/y/y and 1.6%/y/y in Q3 and Q2 respectively. Amid an environment where the

Households' Preference for Fixed Rate Mortgages



Source: RBNZ

economy has approached full capacity (in labour and capital resources), risks are building that a significant rebound in consumer spending and acceleration in house prices could exert inflationary pressure.

For now, short term inflation has improved on the back of the decline in energy prices, with CPI easing to 1.6% in line with RBNZ's inflation target range of 1-3%. However, amid an environment of full capacity coupled with pickup in housing and domestic demand, risks to inflation over the medium term continue to remain significant over the medium term. For now, we believe the RBNZ can afford to remain on hold over the next quarter, allowing the impact of past rate hikes to work through the financial market. For further clues to RBNZ's policy moves, players would be closely monitoring **RBNZ Gov Bollard's speech on the NZ economic outlook** at the Wellington Regional Chamber of Commerce on March 14 (1830gmt).

Soft Landing for Housing

Soft Landing for Housing Market Ideal: While voicing concerns over housing inflation, the RBNZ also appears anxious to buffer the impact of the rate hikes on the housing market. Traditionally, households prefer to hold assets/savings in housing rather than alternative instruments such as equities and bonds. This has resulted in households heavily exposed to any moderation in house prices. The typical household presently commits about 13% of its disposable income to service debt. Such heavy mortgage burden appears to be justified by expectations of capital gains rather than rental yield. Such trends have left households vulnerable to adverse events such as rise in unemployment and interest rates. Indeed, the RBNZ recognizes the need to lift interest rates to contain inflation, yet anxious to prevent a hard landing for the housing market. A soft landing for the housing market appears to be the objective.

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