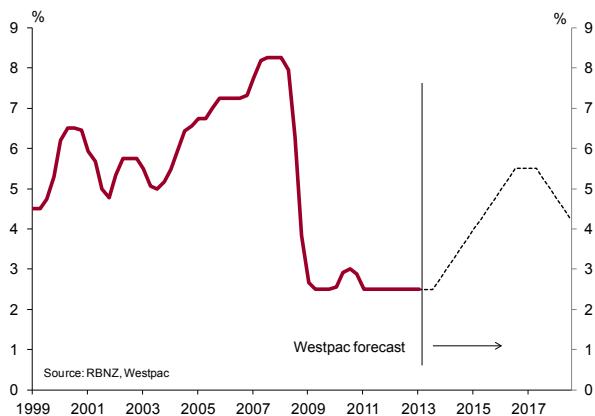


A question of tactics

OCR Preview October 2013

- We expect the overall tone of the October OCR Review will be slightly more dovish than the September *MPS*.
- The RBNZ is likely to express concern about the high exchange rate in the October OCR Review, although its rhetoric around the domestic economy and inflation will be upgraded.
- Subject to confirmation of the Reserve Bank's stance, we are likely to shift our call for the start date of the hiking cycle to April (currently March).

Westpac OCR forecast



Over the course of this year, the Reserve Bank has been gradually building the case for higher interest rates. Its forecasts have been steadily revised in the direction of an OCR hiking cycle that begins earlier and is greater in extent, and its rhetoric has become more pointed. But we expect the October OCR Review will break with that trend. This time, the RBNZ may sound just a little more hesitant about hiking the OCR early, on account of the high exchange rate.

The September *Monetary Policy Statement* signalled that the OCR hiking cycle would begin around April next year. But the RBNZ has been grappling with three key questions that could affect that timing:

- What will happen to the housing market now that restrictions on high loan-to-value (LVR) mortgage lending have been enacted for financial stability reasons?
- To what extent will the Canterbury rebuild and national recovery in construction activity generate inflation pressures?
- To what extent will the high exchange rate depress inflation?

As we consider what next week's October OCR Review might look like, it is useful to align our analysis with those three questions.

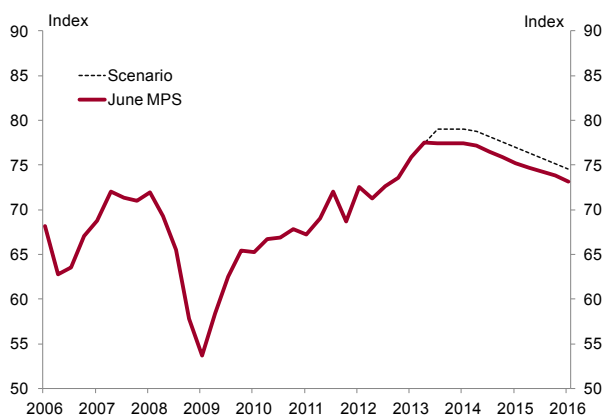
No reliable information has come to light regarding the impact of LVR restrictions on house prices – it is just too soon.

Regarding the construction boom and inflation pressure, recent developments have probably bolstered the case for OCR hikes. Indicators of economic activity have been stronger than the RBNZ anticipated, and September quarter inflation was slightly higher than the RBNZ forecast. Importantly, there are increasing signs that nationwide construction cost inflation is gathering a head of steam.

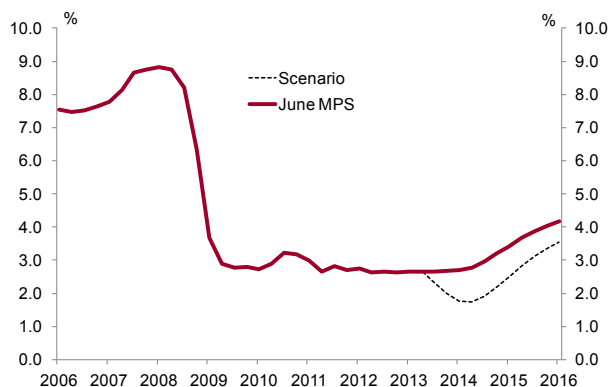
But the most important change since September is the exchange rate. The Trade Weighted Index has risen 4%, whereas the September *MPS* was predicated on an unchanged exchange rate. Back in June, the Reserve Bank illustrated just how important the exchange rate is for monetary policy. At the time, its central projection was based on a stable exchange rate, and suggested that the OCR would gradually rise. But the RBNZ also portrayed an alternative scenario in which the

exchange rate rose an extra 2% on a sustained basis. In that alternative scenario, the OCR was slated to fall (see charts).

June MPS forecast and alternative scenario - Trade Weighted Index



June MPS forecast and alternative scenario - 90-day interest rate



Admittedly, the recent lift in the exchange rate is not entirely comparable to the June alternative scenario. For a start, the RBNZ cannot yet tell whether the exchange rate will be sustained at these levels. And second, the June scenario was a “portfolio shock”, in which the exchange rate appreciation did not reflect any relative improvement in the New Zealand economy. That’s not entirely the case here. Some of the recent appreciation in the exchange is a consequence of extremely high export commodity prices and the improving domestic economy, and will not concern the RBNZ. But another portion of the exchange rate appreciation probably can be classified as a portfolio shock – it reflects the US Federal Reserve’s decision not to taper its quantitative easing program.

A question of tactics

On balance, the higher exchange rate will outweigh the stronger domestic economy so far as the RBNZ’s modelling and forecasting is concerned. But the RBNZ may not want to signal

that it is second-guessing the start date of the OCR hiking cycle at this stage. Exchange rates are fickle, and responding to every gyrations can make a central banker look like a flip-flopper. Furthermore, a dovish signal now could cause a fall in fixed term mortgage rates, which would add fuel to the housing market fire. So the RBNZ may choose to tread softly.

In the October OCR Review, we expect the RBNZ will upgrade its rhetoric around the domestic economy and inflation, but will balance that out by labelling the exchange rate overvalued and damaging to the tradables sector. One innovation might be for the Reserve Bank to introduce the exchange rate into its statement of conditionality. The penultimate sentence of the September MPS press release was:

“The extent and timing of the rise in policy rates will depend largely on the degree to which momentum in the housing market and construction sector spills over into broader demand and inflation pressures.”

The RBNZ could usefully tack onto the end of that sentence the words *“and on the trajectory of the exchange rate.”*

A more extreme option, which we regard as possible but by no means likely, would be for the Reserve Bank to say something along the lines of *“should the exchange rate remain elevated, the need for tighter monetary policy may be reduced.”*

Market implications

From a financial market perspective, the balance of risks here is skewed towards a fall in interest rates on the day. If the Review follows our expectations by acknowledging that the outlook for the OCR is conditional on the exchange rate, then swap rates would probably fall slightly. If the RBNZ opts for the more extreme option mentioned above, swap rates would fall sharply.

To us, there is little chance of the Reserve Bank issuing a hawkish OCR Review that causes a material increase in swap rates.

Westpac’s OCR call

Our own forecast, unchanged since April, has been that the strength of the domestic economy would force the RBNZ to begin the OCR hiking cycle in March 2014. However, recent developments are starting to point to a later start date.

We still believe the domestic economy is going from strength to strength. But the exchange rate is now uncomfortably high, and we expect the TWI will still be above 78 next March. And as we have mentioned elsewhere, we expect the housing market will soon slow in response to sharply higher fixed mortgage rates and the LVR restrictions.

Subject to confirmation that next Thursday’s OCR Review is along the lines we expect, we are likely to shift our call to forecasting an April 2014 start date to the OCR hiking cycle.

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