Westpac

Institutional Bank

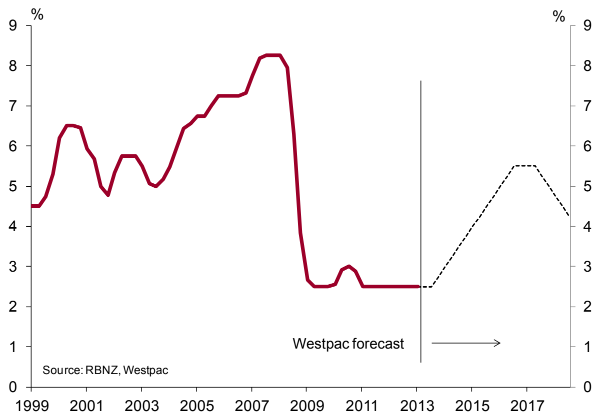
23 October 2013

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?

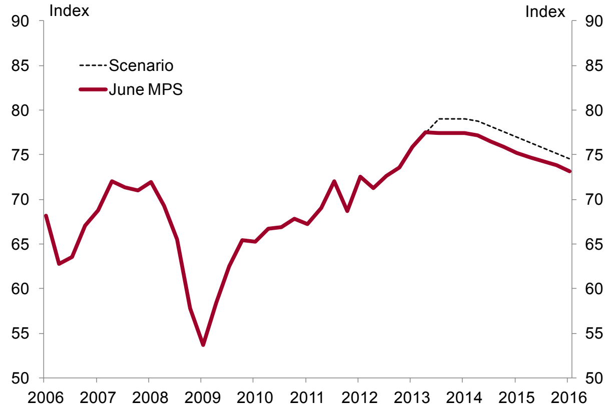
As we consider what next week's October OCR Review might look like, it is useful to align our analysis with those three questions.

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

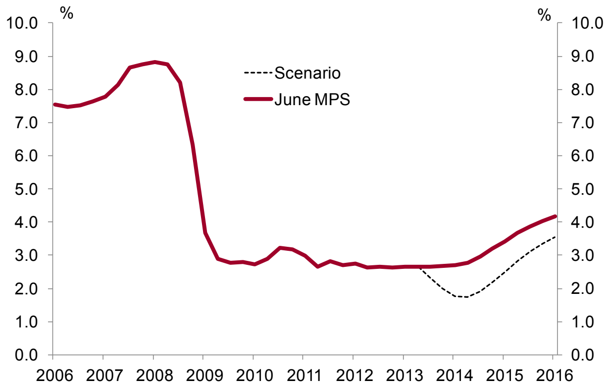
Regarding the construction boom and inflation pressure, recent developments have probably bolstered the case for OCR hikes. Indicators of economic activity have been stronger than the RBNZ anticipated, and September quarter inflation was slightly higher than the RBNZ forecast. Importantly, there are 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 gyration 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.

Dominick Stephens
Chief Economist

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Anne Boniface, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

For email address changes contact:
WNZResearch@westpac.co.nz

Disclaimer

Disclaimer continued overleaf.

Disclaimer continued

Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

U.K.: Westpac Banking Corporation is registered in England as a branch (branch number BR000106), and is authorised and regulated by the Australian Prudential Regulatory Authority in Australia. WBC is authorised in the United Kingdom by the Prudential Regulation Authority. WBC is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority in the United Kingdom. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. This material and this website and any information contained therein is directed at a) persons who have professional experience in matters relating to investments falling within Article 19(1) of the Financial Services Act 2000 (Financial Promotion) Order 2005 or (b) high net worth entities, and other persons to whom it may otherwise be lawfully communicated, falling within Article 49(1) of the Order (all such persons together being referred to as “relevant persons”). The investments to which this material and this website relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this material and this website or any of its contents. In the same way, the information contained in this material and this website is intended for “eligible counterparties” and “professional clients” as defined by the rules of the Financial Services Authority and is not intended for “retail clients”. With this in mind, Westpac expressly prohibits you from passing on the information in this material and this website to any third party. In particular this material and this website, website content and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission (“CFTC”) as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC (‘WCM’), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 (‘the Exchange Act’) and member of the Financial Industry Regulatory Authority (‘FINRA’). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.

For the purposes of Regulation AC only: Each analyst whose name appears in this report certifies that (1) the views expressed in this report accurately reflect the personal views of the analyst about any and all of the subject companies and their securities and (2) no part of the compensation of the analyst was, is, or will be, directly or indirectly related to the specific views or recommendations in this report.