

# Shine a light

## September 2013 MPS Review: OCR unchanged at 2.50%, hikes likely next year

- **The Reserve Bank delivered a clear message today that it is likely to begin an extended series of interest rate hikes from next year.**
- **The September *Monetary Policy Statement* fleshed out the shift in stance that was signalled in the July OCR review.**
- **The RBNZ is becoming more concerned about the inflation consequences of the construction boom and rising house prices – even with loan restrictions and higher mortgage rates leaning against the latter.**
- **Our long-held view that OCR hikes will begin in March 2014 is now broadly matched by the RBNZ's projections, as well as market pricing.**

The last Official Cash Rate (OCR) review in July marked a shift in the Reserve Bank's monetary policy stance, introducing an explicit discussion of interest rate hikes for the first time since late 2011. For the most part, today's *Monetary Policy Statement (MPS)* served to shed light on just how significant that July shift was – if anything, upping the ante slightly on the case for rate hikes.

As for what's prompted the change in stance – in part it's a growing confidence that the New Zealand economy has entered a sustained upturn, aided by a construction boom and rising house prices. But there's also a sense that the RBNZ's long-held assumptions that these two forces would have benign inflationary effects are now being challenged. That means that even with a slightly softer outlook for house price growth – thanks to the recent loan restrictions and higher fixed-term mortgage rates – the degree of upward pressure on inflation is seen as more severe than in June.

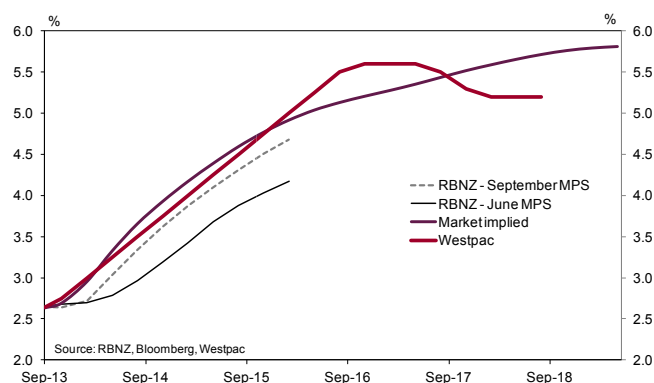
### Details

The bottom line of today's statement largely retained the language used in July. Firstly, the OCR is expected to remain unchanged this year, but hikes "will likely be required next year". Secondly, there's no longer any question about the direction of the next move in rates, only the degree: "The extent and timing of the rise in policy rates will depend largely on the degree to which the momentum in the housing market and construction sector spills over into broader demand and inflation pressures".

The most telling measure of how the RBNZ's view of the world has shifted in recent months is in its projections for the 90-day interest rate. Compared to the pallid series of OCR hikes that was projected in the June *MPS*, today's statement projected a

substantial tightening cycle beginning around April next year and proceeding at a pace equivalent to one OCR hike per quarter. By the early 2016 cut-off for the published forecasts, the 90-day rate is projected to be at 4.7% (and rising) – a full 50 basis points higher than what was projected in June. That now puts the RBNZ broadly in line with our forecast of an extended tightening cycle from March 2014.

### 90-day rate expectations



The RBNZ's other economic forecasts were less revealing in themselves, with only modest changes to the outlook for GDP growth, unemployment and inflation compared to the June *MPS*. All together, this suggests that the RBNZ sees substantially more inflation pressures developing over the next few years, but has chosen to offset these pressures through higher interest rates.

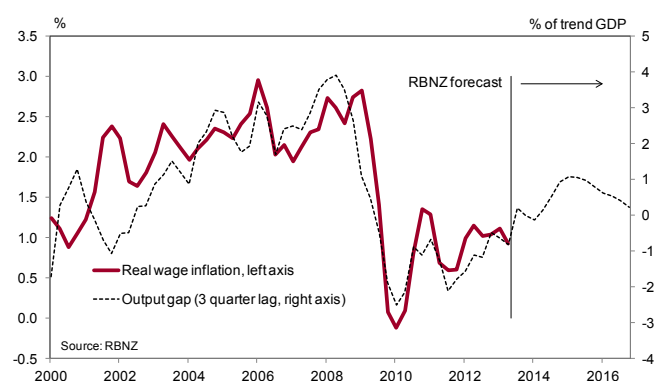
The RBNZ expects annual GDP growth to accelerate to 3% by the year to September 2013, peaking at 3.5% by mid-2014. At least in the near term, those growth forecasts are likely to be disappointed – the *MPS* estimates 0.4% growth in the June quarter GDP figures released next week, but data received since the forecast was finalised suggests that growth will be closer to zero. (We expect a 0.1% decline, which we'll detail in our preview tomorrow.) Annual inflation is expected to return above 1% in the September quarter, partly due to higher fuel prices and the recent drop in the New Zealand dollar, but only rising gradually from there to the 2% midpoint of the RBNZ's target band.

The apparent lack of impact from the lower exchange rate may come as a surprise to some, given that in the past the RBNZ has made much of the idea that even a modest upside surprise on the exchange rate could warrant interest rate cuts. The actual relationship is more complex than that, however. The recent

fall in the dollar creates a bit more upward pressure on prices in the near term. But going forward, a stronger interest rate track means that the RBNZ expects the currency to depreciate more slowly than in the June projections. The slower rate of declines actually implies a lesser rate of increase in the prices of tradable goods and services.

All together, the RBNZ seems increasingly confident that the economy has entered a sustained upswing, aided by a construction boom in Canterbury and elsewhere. It estimates that activity has now by and large returned to its non-inflationary 'potential' level, and will rise above this point in coming years, putting more upward pressure on wages and prices.

### Output gap and annual real wage inflation – RBNZ forecast



But that picture hasn't changed dramatically in the last few months. Rather, what seems to have prompted the RBNZ's more hawkish stance is that some of its long-held assumptions are coming under threat. The RBNZ had taken the view that rising house prices would not provoke much extra consumer spending, and that the Canterbury rebuild would prove less inflationary than past construction booms. In contrast, we've long been saying that the inflationary effects of this cycle would be no different to past cycles. The recent evidence has been more in favour of our view, and by the July OCR review the RBNZ was acknowledging that too.

### LVR restrictions

Perhaps the most challenging development since June is the introduction of restrictions on high loan-to-value (LVR) mortgage lending, which were announced in August. While the stability of the banking system is the primary motivation for these new rules, the RBNZ has made it clear that a slowdown in the rate of house price growth will be the measure of their success – and a slowdown in the housing market would have implications for monetary policy to the extent that it affects household consumption and housing-related price pressures.

The RBNZ's forecasts assume that the LVR restrictions will reduce the rate of house price inflation by 2.5 percentage points over the next year, making the tightening effect of the

restrictions equivalent to 30 basis points' worth of OCR hikes. Those figures are telling, for two reasons. Firstly, the fact that the RBNZ could raise its interest rate track by as much as 50 basis points, even after lopping off 30 points for the LVR restrictions, indicates that they perceive a great deal more inflation pressure relative to the June MPS. Secondly, it suggests that the RBNZ's forecasts have become more sensitive to house price inflation than they may have been in the past – otherwise, it's hard to see how they could have been so sanguine about the surge in house prices up until the June MPS.

The RBNZ's house price forecasts are actually only slightly softer than they were in June – a stronger underlying picture partly offsets the impact of both the LVR restrictions and the substantial rise in fixed-term mortgage rates in the last few months. That said, that RBNZ seems more confident that house price growth is close to peaking and will slow next year. We're inclined to agree – the rise in mortgage rates puts the housing market much closer to being fairly valued than it was even three months ago.

We agree with the RBNZ's new stance. We have long argued that rising house prices and a construction boom would eventually provoke inflation pressures and would require a substantial OCR hiking cycle, similar to the experience of past decades. It is right for the central bank to warn markets and the public that a period of higher interest rates is coming. Indeed, moving early in this manner may limit the eventual extent of OCR hikes that are required – the anticipation of future OCR hikes has caused markets to push fixed mortgage rates up, which will slow the housing market earlier than OCR hikes on their own could have.

### Market implications

Markets viewed the statement as slightly more hawkish than expected. Swap rates rose by 2 basis points, and the NZD/USD exchange rate jumped half a cent to 0.8130. Interest rate markets are fully pricing in a 25bp hike by March next year, and are toying with the possibility of an even earlier move.

We suspect that the burden of proof for kicking off a tightening cycle earlier than March is fairly demanding – for one thing, it would pay to see what impact the LVR restrictions have as they are phased in over coming months. Moreover, the RBNZ can already successfully guide market interest rates higher through clearly signalling its intentions; it has little to gain – and much to lose in terms of reputation – by going back on its expectation for no OCR hikes this year. So we'd rule out a December OCR hike, but it's increasingly likely that rate hikes will kick off early next year.

### Dominick Stephens

Chief Economist

### Michael Gordon

Senior Economist

**RBNZ media release**

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

Reserve Bank Governor Graeme Wheeler said: “The global outlook remains mixed. GDP growth in Australia and China has slowed and some emerging market currencies have come under considerable downward pressure. At the same time, the major developed economies continue to recover and New Zealand’s export commodity prices remain very high.

“Although long-term interest rates have risen globally in recent months, largely due to uncertainty around the timing of the Federal Reserve’s exit from quantitative easing, global financial conditions overall continue to be very accommodating.

“In New Zealand, GDP is estimated to have increased by 3 percent in the year to the September quarter. Consumption is rising and reconstruction in Canterbury will be reinforced by a broader national recovery in construction activity, particularly in Auckland. This will support aggregate activity and start to ease the housing shortage.

“In the meantime rapid house price inflation persists in Auckland and Canterbury. As has been noted for some time, the Reserve Bank does not want to see financial or price stability compromised by continued high house price inflation. Restrictions on high loan-to-value residential mortgage lending, which will come into effect next month, are expected to help slow the national housing market.

“Despite having fallen on a trade-weighted basis since May 2013, the exchange rate remains high. A lower rate would reduce headwinds for the tradables sector and support export industries. Fiscal consolidation will weigh on aggregate demand over the projection horizon.

“CPI inflation has been very low over the past year, partly reflecting the high New Zealand dollar and strong international and domestic competition. However, inflation is expected to rise towards the mid-point of the 1 to 3 percent target band as growth strengthens over the coming year.

“OCR increases will likely be required next year. The extent and timing of the rise in policy rates will depend largely on the degree to which the momentum in the housing market and construction sector spills over into broader demand and inflation pressures. We expect to keep the OCR unchanged in 2013.”

## 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

**Nathan Penny**, Economist  
+64 9 336 5669

Any questions email:  
economics@westpac.co.nz

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

## Disclaimer

**Things you should know:** Each time someone visits our site, data is captured so that we can accurately evaluate the quality of our content and make improvements for you. We may at times use technology to capture data about you to help us to better understand you and your needs, including potentially for the purposes of assessing your individual reading habits and interests to allow us to provide suggestions regarding other reading material which may be suitable for you.

If you are located in Australia, this material and access to this website is provided to you solely for your own use and in your own capacity as a wholesale client of Westpac Institutional Bank being a division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ('Westpac'). If you are located outside of Australia, this material and access to this website is provided to you as outlined below.

This material and this website contain general commentary only and does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material and this website may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material and this website does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. The forecasts given in this material and this website are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Transactions involving carbon give rise to substantial risk (including regulatory risk) and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. Statements setting out a concise description of the characteristics of carbon units, Australian carbon credit units and eligible international emissions units (respectively) are available at [www.cleanenergyregulator.gov.au](http://www.cleanenergyregulator.gov.au) as mentioned in section 202 of the Clean Energy Act 2011, section 162 of the Carbon Credits (Carbon Farming Initiative) Act 2011 and section 61 of the Australian National Registry of Emissions Units Act 2011. You should consider each such statement in deciding whether to acquire, or to continue to hold, any carbon unit, Australian carbon credit unit or eligible international emissions unit.

### **Additional information if you are located outside of Australia**

**New Zealand:** The current disclosure statement for the New Zealand division of Westpac Banking Corporation ABN 33 007 457 141 or Westpac New Zealand Limited can be obtained at the internet address [www.westpac.co.nz](http://www.westpac.co.nz). Westpac Institutional Bank products and services are provided by either Westpac Banking Corporation ABN 33 007 457 141 incorporated in Australia (New Zealand division) or Westpac New Zealand Limited. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at [www.westpac.co.nz](http://www.westpac.co.nz).

**China, Hong Kong, Singapore and India:** Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activity.

**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 be 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.