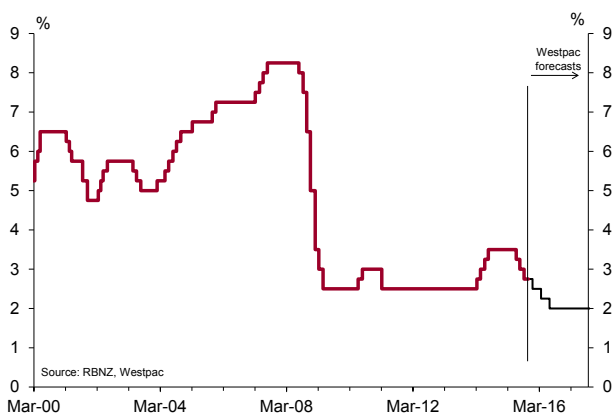


Should I stay or should I go

Preview of RBNZ Monetary Policy Statement, December 2015

- Next week's Monetary Policy Statement is highly uncertain, and could produce large market reactions.
- The OCR remained on hold in October, but since then the outlook has shifted in a direction that favours OCR cuts.
- The RBNZ is most likely to cut the OCR 25bps, while sounding neutral about future OCR changes. In this case, the exchange rate and interest rates would fall modestly.
- It is less likely, but possible that the RBNZ will keep the OCR on hold while firmly signalling cuts for early-2016. In that case, the exchange rate and interest rates would rise sharply.

Westpac OCR forecast



Some OCR decisions are clear cut affairs, and others are uncertain right through to the last minute. Next week's December *Monetary Policy Statement* is of the uncertain variety, which will make it a key event for markets.

The OCR is currently 2.75%, and the RBNZ's forecasts and communications have all indicated that it sees 2.5% as the low-point in the current OCR cycle. That means the RBNZ expects to deliver only one more OCR cut. Next week's OCR decision comes down to whether the RBNZ wants to fire what it sees as its final bullet, or whether it wants to keep its powder dry.

We think the most likely outcome is a 25 basis point OCR cut. The RBNZ held off in October, but since then the situation has evolved more clearly in a direction favouring OCR cuts. Reasonable arguments can still be constructed for either immediate action or for waiting (as shown below). But on balance, the arguments for cutting immediately are more compelling.

If the RBNZ does cut next week, then the accompanying statement will seek to avoid commitment. In particular, the RBNZ is unlikely to remove the possibility of further rate cuts by signalling a "period of stability", for fear of markets overreacting and the exchange rate rising. Neither would we expect the RBNZ to adopt an explicit easing bias. Instead, we expect the RBNZ to adopt language that is open to either keeping the OCR on hold or reducing it, such as:

"Future OCR decisions will depend on the emerging flow of data."

Presumably the context of the Monetary Policy Statement, including the usual alternative scenarios, will make it clear that OCR hikes will be off the table for a long time. The RBNZ may even go as far as to emphasise that point in the press release, by saying something along the lines of:

"The OCR is expected to remain low for some time."

We consider it less likely – but not inconceivable – that the RBNZ will leave the OCR unchanged next week, but will firmly signal that a cut is likely in the months ahead.

If I go there will be trouble

While there are arguments both for and against an OCR cut in December, we find the arguments for a cut more compelling. These include:

- **Low dairy prices.** This was a major concern of the RBNZ's in September. An encouraging rise in dairy prices was probably a factor in the RBNZ leaving the OCR on hold in October. But global dairy prices have subsequently fallen again, and many farmers are facing a second season of negative returns.
- **The exchange rate remains higher than the RBNZ would like.** In October, the RBNZ drew an explicit link between the exchange rate and the OCR: *"...the exchange rate has been moving higher since September, which could, if sustained, dampen tradables sector activity and medium-term inflation. This would require a lower interest rate path than would otherwise be the case."* The high exchange rate has indeed been sustained.
- **Inflation is likely to prove lower than the RBNZ's previous forecast.** The RBNZ's previous forecast for December quarter inflation was 0.2%. But after observing a drop in petrol prices, food prices and general weakness in retail prices, we have concluded that quarterly inflation in December will actually be closer to -0.2%. Some might be tempted to "look through" inflation weakness emanating from the likes of food and petrol prices. That would be a mistake – this is a continuation of the very global themes that caused New Zealand inflation to fall so low in the first place.
- **The Auckland housing market slowed with a thump in October.** This should ameliorate the RBNZ's concerns about low interest rates stoking financial stability risks.
- **An on hold decision would cause the exchange rate to rise.** If the RBNZ keeps the OCR on hold for a second consecutive meeting, markets would cast doubt on any signal about future cuts. Instead, markets would probably conclude that there is little chance of the OCR going below 2.75%. Two year swap rates and the exchange rate would rise accordingly – the latter being something the RBNZ is keen to avoid.

If I stay it will be double

There are, of course, reasonable arguments against cutting the OCR, including:

- Recent data on economic activity in New Zealand has tended to be quite strong – for example, retail sales volumes were up 1.6% in the September quarter, and business confidence has risen convincingly.
- It now seems highly likely that the Federal Reserve will hike US interest rates in December (a week after the RBNZ's

decision date). If the Fed does hike, the New Zealand dollar could be driven down, which would boost inflation in New Zealand.

- The RBNZ might down-weight the weak October housing data, and instead focus on the fact that the level of Auckland house prices is too high for comfort.
- Given the uncertainty around the exchange rate and housing market, the RBNZ may decide it is prudent to wait before taking action on the OCR. If a cut is needed, there is little harm in delaying it a few months. Conversely, delivering an OCR cut that proves unwarranted would be a difficult mistake to unwind.

While these are all valid points, we find them less compelling than the arguments in favour of an immediate OCR cut. In particular, even if the Fed hikes, the exchange rate tumbles, and house prices keep rising, there is still little chance of inflation exceeding 2% on a sustained basis. By contrast, if the exchange rate stays high, Auckland house prices fall, and global inflation remains low, it is quite plausible that inflation will settle well below the RBNZ's 2% target. So the balance of risks seems clear enough to warrant immediate action.

Market reaction

This is a highly uncertain OCR Review that could produce large market reactions. It is best to consider the range of possible market reactions that match the range of possible RBNZ actions:

- If the RBNZ keeps the OCR on hold, the exchange rate and interest rates will rise sharply, even if the RBNZ signals that future easing is likely.
- If the RBNZ cuts the OCR but rules out further cuts, the exchange rate and interest rates would rise more moderately. (This is the least likely scenario).
- If the RBNZ cuts the OCR, and is neutral and non-committal about future OCR changes, the exchange rate and interest rates would fall moderately. (The most likely scenario).
- If the RBNZ cuts the OCR and expresses a likelihood of further cuts to come, the exchange rate and interest rates would fall sharply.

Westpac's OCR call

Since July this year we have been of the view that the OCR will eventually fall to 2.0%. We remain firmly of that view. We are forecasting OCR cuts in December 2015, March 2016, and June 2016.

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

Satish Ranchhod, Senior Economist
+64 9 336 5668

Anne Boniface, Senior Economist
+64 9 336 5669

David Norman, Industry Economist
+64 9 336 5656

Any questions email:
economics@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 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. 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.

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. 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.