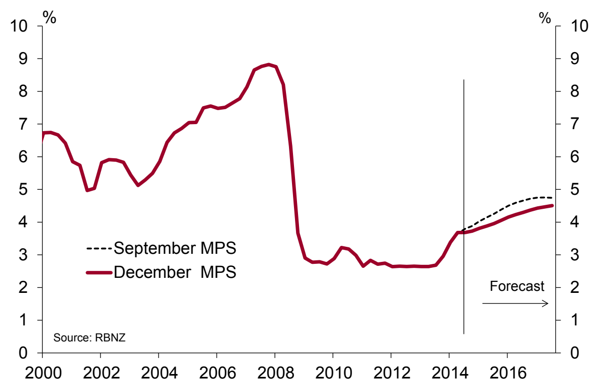
11 December 2014

Overtaken by events

December 2014 MPS Review: OCR on hold at 3.50%

- As expected, the Reserve Bank today left the Official Cash Rate (OCR) on hold and pushed out the expected timing of future interest rate hikes.
- The RBNZ has become more optimistic about the economy's capacity to grow without inflation, and has substantially upgraded its GDP forecasts over coming years.
- We feel that the RBNZ's forecasts are already being overtaken by events. Lower oil prices and a strong currency could see inflation fall below 1% again over the next year, while the housing market is heating up again.
- In these circumstances, we see interest rate hikes being delayed until 2016, but with macroprudential policy perhaps coming into play again next year.

90-day rate forecasts, Dec versus Sep MPS



In terms of the bottom line for interest rates, the message from today's *Monetary Policy Statement* was very much what we expected. With the economy expected to keep growing at an above-trend pace for the next couple of years, inflation pressures will eventually re-emerge and higher interest rates will be needed. However, inflation remains low for now, and has continued to surprise on the downside, for reasons that are still being investigated. As a result, those interest rate hikes are likely to be later and less extensive than the Reserve Bank previously thought.

The foreign exchange market seemed to be surprised by this message, sending the New Zealand dollar more than a cent higher this morning. In particular there was some surprise at the re-introduction of the statement that "some further increase in the OCR is expected to be required". This phrase was removed from the October OCR review statement, leading some in the market to conclude that the RBNZ had dropped its tightening bias. We argued at the time that the tightening bias was still intact if you read between the lines of the statement; today's *MPS* makes it explicit again.

While the RBNZ's published projections themselves don't raise any concerns for us, we feel that they are already being overtaken by events. In the last few weeks there have been some major developments in terms of oil prices, the exchange rate and the housing market. The first two are clearly downside risks to the RBNZ's inflation forecasts. In contrast, the risks to house prices are to the upside, although the implications for inflation are not so clear-cut.

As we detailed in yesterday's bulletin, we now expect annual inflation to fall below the bottom of the RBNZ's 1-3% target band over the next year, before picking up strongly in later years. We suspect that the RBNZ will want some clear evidence that inflation is returning to within the target band – and staying there – before raising interest rates again, and on our forecasts that evidence won't be forthcoming until early 2016.

That said, the RBNZ may well spend the next year warning of interest rate hikes – and certainly downplaying the chances of rate cuts – in order to avoid pumping up an already-buoyant housing market. In that sort of environment, macro-prudential tools are likely to form part of the policy debate again.

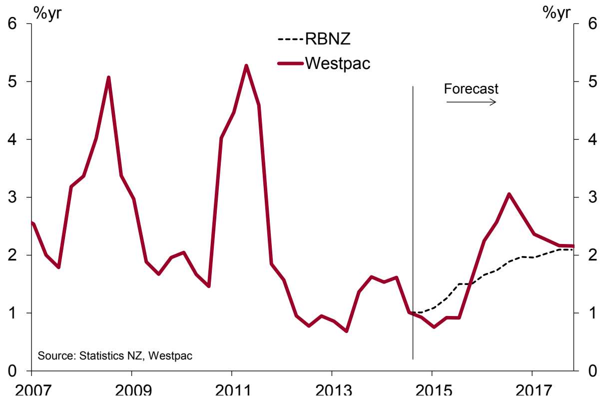
Forecast details

As we expected, the RBNZ lowered its 90-day interest rate projections by around 30 basis points compared to the September *MPS*. The new projection effectively implies that only another three OCR hikes will be needed over the next three years, with the December 2015 quarter as the most plausible timing of the next OCR hike.

The RBNZ has continued to be surprised by the economy's capacity to grow without generating much inflation. Significantly, the RBNZ's research now suggests that the downside surprises on inflation have been on the non-tradables side, which is more amenable to monetary policy settings (in contrast, tradables inflation has behaved as would be expected, given the usual drivers such as the exchange rate). Consequently, the RBNZ has substantially upgraded its estimates of both potential and actual growth over the next few years – it now expects GDP growth to be running above 3% through to early 2017, a view that we more or less share.

The RBNZ lowered its near-term inflation forecasts to incorporate the softer than expected September quarter outturn. Annual inflation is now expected to reach jut 1.3% by June next year, compared to the previous forecast of 1.7%. However, beyond this point there was very little change to the RBNZ's inflation forecast – the non-tradables inflation forecast was reduced, reflecting the economy's higher growth potential, but the tradables inflation forecast was increase on the assumption that the exchange rate will continue to fall.

Inflation forecasts, RBNZ versus Westpac



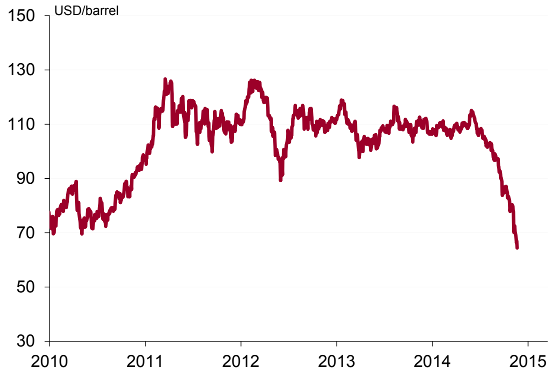
On that note, the RBNZ repeated its now-standard statement that it sees the level of the exchange rate as "unjustified" and "unsustainable", and that it expects a further significant deprecation.

Risk factors

The RBNZ noted a number of risks to its inflation projections. As it discussed in detail in the September *MPS*, there are lingering questions about the strength of the linkages between housing, migration, the exchange rate, expectations and inflation. In addition, it cited some specific risks that could affect the outlook: the effects of lower dairy prices on domestic spending, the strength of the housing market, and the impact of lower oil prices.

We feel that some of the RBNZ's projections already starting to look dated since they were finalised in late November. Firstly, world oil prices have fallen even further than anticipated. The RBNZ's projections assume that Dubai oil prices will hold at around $80-85 per barrel over the next few years, but the actual price has since dropped well below $70. As we detailed in our bulletin yesterday, this alone makes it likely that inflation will fall below 1% over the next year.

Dubai crude oil price



The effect of plunging world oil prices would be compounded if the currency remained stubbornly high. We're not so convinced that the US dollar is destined to head higher once the Federal Reserve starts to raise interest rates – it's just as plausible that a stronger US economy will be seen as a positive driver for the rest of the world, which would see funds flow from the US into higher-yielding destinations such as emerging markets and commodities. Moreover, the New Zealand dollar will struggle to weaken on a trade-weighted basis when some of our major trading partners – Europe, Japan and Australia – are either loosening monetary policy or are about to do so.

As for the housing market, figures released by REINZ just yesterday show a dramatic resurgence in the housing market over the last two months, and while the RBNZ took a cautious stance in its comments today, there was a clear sense that housing has quickly become a front-of-brain issue again for the RBNZ. We think that rising population and lower mortgage rates will see house price inflation exceed the RBNZ's forecasts.

That said, house price growth to date has probably had less impact on inflation than expected, and if that situation persists, it's not obvious that the RBNZ would need to respond with earlier interest rate hikes. Instead, it's more likely that the RBNZ would address house prices directly using macroprudential tools, as it did in 2013 when the housing market was booming but inflation was below target.

We note that RBNZ Governor Wheeler said today that they are not contemplating further macroprudential tools at the moment, but we suspect that their thinking will evolve over time. Bear in mind that as late as December 2012 the Governor told Parliament that "as we see the housing market at present on a national basis, and given the credit growth figures that I talked about, we wouldn't see the need to use LV ratios at this point in time". Eight months later the RBNZ introduced a cap on high-LVR lending.

Dominick Stephens
Chief Economist

Michael Gordon
Senior Economist

RBNZ media release

The Reserve Bank today left the Official Cash Rate unchanged at 3.5 percent.

The global economy continues to grow at a moderate pace, though recent data suggest a softening in major economies other than the United States. Inflation remains below target in most of the advanced economies due to spare capacity and declining commodity prices. Monetary policy is expected to remain very supportive for some time.

New Zealand's economic growth is running at an annual rate of around 3½ percent. While dairy prices have declined sharply, domestic demand has retained momentum, supported by the ongoing growth in consumption and construction activity. Interest rates are low by historical standards and continue to support domestic demand. The exchange rate does not reflect the decline in export prices this year and remains unjustifiably and unsustainably high. We expect to see a further significant depreciation.

CPI inflation remains modest, at 1 percent in the year to September. Weak global inflation, falls in international oil prices and the high exchange rate are the main influences. Inflation in the non-tradeables sector remains subdued with capacity pressures having less impact than usual.

Growth is expected to remain at or above trend through 2016, with unemployment continuing to decline. Modest inflation pressures suggest the expansion can be sustained for longer than previously expected with a more gradual increase in interest rates. Underpinning this, the economy's productive capacity is being boosted by high labour force participation, strong net immigration and continued investment growth.

Risks to the growth outlook include dairy prices, which are expected to recover in 2015, the overvalued exchange rate, and the strength of construction activity. Inflation risks include the impact of rising capacity pressures on domestic inflation, the response of house prices to the strong migration inflows, and the impact of lower oil prices.

With output projected to grow at or above capacity, CPI inflation is expected to approach the 2 percent midpoint of the Reserve Bank's target range in the latter part of the forecast period. Some further increase in the OCR is expected to be required at a later stage. Further policy adjustments will depend on data emerging over the assessment period.

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

Satish Ranchhod, Senior Economist
+64 9 336 5669

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.