Westpac

Institutional Bank

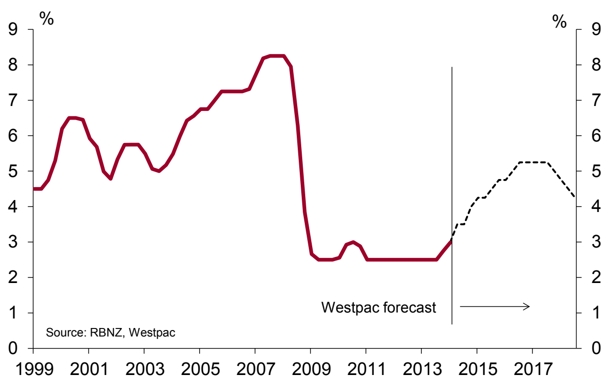
17 July 2014

Cat among the pigeons

RBNZ July 2014 OCR preview

- A spate of weak data has raised legitimate questions about the appropriate pace of OCR hikes in New Zealand.
- Next week's July OCR Review is no longer a "done deal". However, on balance we still believe the RBNZ will hike the OCR by 25 basis points.
- The accompanying press release will restate the RBNZ's main message that, over the coming years, the OCR is likely to rise substantially.
- However, the RBNZ will probably also state that it intends to briefly pause the programme of OCR hikes after July.
- We now expect this pause will last until January 2015 (previously December 2014).
- The RBNZ might consider intervening in currency markets by selling New Zealand dollars after the July OCR Review.

Westpac OCR forecast



The July OCR Review was supposed to be a slam dunk. After the June *Monetary Policy Statement*, we were left in no doubt that the Reserve Bank planned to hike the OCR by 25 basis points at the July OCR Review – unless, of course, some extreme data surprise came along to cancel the hike.

Since June, there has not been any single event that could be categorised as "extreme". But over the past few weeks New Zealand has experienced a constellation of economic developments that, in unison, does raise questions about the urgency for OCR hikes.

Most important among these developments is precipitous declines in dairy and log export prices. This is quite different to the period of falling dairy price in March and April – that was anticipated by the Reserve Bank, whereas the latest episode was not. To make matters worse for exporters, the exchange rate is now even higher than it was early in the year.

On the domestic front, the economy has lost some of its (considerable) momentum, and the Consumers Price Index has failed to produce a "smoking gun" of accelerating non-tradables inflation. Fixed mortgage rates, which had been too low for the Reserve Bank's liking, have risen sharply. The solitary "upside" development of the past few weeks has been net immigration, which has again turned out stronger than the RBNZ anticipated.

After mulling this plethora of downside developments, we are sure that the Reserve Bank will conclude that the requirement for OCR hikes has attenuated – but has not been eliminated. The June MPS showed that the RBNZ expected to lift the OCR by 1.5 percentage points over the next two years. The requirement may now be for the OCR to rise by only 1.25 percentage points.

The latest data developments may even provoke a lively discussion within the RBNZ as to whether an OCR hike next week is still warranted. But ultimately, we think the RBNZ will proceed with the hike, for the following reasons:

- The current RBNZ administration has built an admirable record of clear and accurate communication regarding future OCR changes. Failing to hike next week would risk squandering that hard-won credibility.
- The RBNZ has always maintained that its hiking cycle would be "front-loaded" – that is, OCR hikes would be rapid at first, and slow later. There is no reason to shy away from that strategy.
- In an alternative scenario within the June MPS, the RBNZ indicated what it would do if export prices deteriorated unexpectedly. In that scenario, the RBNZ indicated it would still hike the OCR in a front-loaded fashion, but would proceed with a slower pace of OCR hikes later.

Although we expect the RBNZ to persist with its hike next week, the recent bout of weaker data has strengthened the case for a "pause" in the OCR hiking cycle beyond July. Such a pause was always the RBNZ's plan. Whereas we previously expected the hiking cycle to resume in December 2014, we now anticipate a lengthier pause. At the end of this year we expect inflation will still be just 1.6%, and we doubt that the housing market will rebound as vigorously as the RBNZ fears. **We are now forecasting the OCR to remain at 3.5% from July until January 2015 (see table).**

Westpac OCR forecast

	Previous Forecast	Current Forecast
July 2014	3.5%	3.5%
September 2014	3.5%	3.5%
October 2014	3.5%	3.5%
December 2014	3.75%	3.5%
January 2015	4.00%	3.75%
March 2015	4.25%	4.00%
April 2015	4.25%	4.25%
June 2015	4.25%	4.25%

RBNZ communication

The one-page press release accompanying the OCR decision will of course acknowledge the various economic developments that have conspired to weaken the inflation outlook. In particular, the RBNZ is sure to decry the inconsistency between the stratospheric New Zealand dollar and deteriorating export conditions.

When it comes to the OCR outlook, the RBNZ will attempt to find a way of clearly signalling a pause, while reaffirming the overarching message that the OCR will rise gradually over the coming years. The RBNZ always places a high premium on providing clear guidance about upcoming OCR decisions, because this helps to control interest rates. But there is a second motivation for clarity in the current circumstances – the September MPS is nine days before a general election. The best way for the RBNZ to avoid becoming a political football and stay out of the headlines is to ensure there are no news-worthy surprises on the day.

The RBNZ seems pretty good at delivering such nuanced messages – in the past it has simply bluntly stated its intention. For example, the October 2013 OCR Review could not have been clearer: *"Although we expect to keep the OCR unchanged in 2013, OCR increases will likely be required next year."*

The RBNZ may take a similar approach next week. Our attempt at drafting the "bottom line" of the OCR Review reads something like:

"For now, a short period of stability in the OCR seems appropriate. Over time, further OCR increases are likely to be needed to keep future average inflation near the 2 percent target mid-point. The speed and extent to which the OCR will need to rise will depend on future economic and financial data, including the exchange rate, and their implications for inflationary pressures."

Market reaction to a statement along these lines would be slight.

A word on currency intervention

Once the July OCR Review is out of the way, the RBNZ may consider intervening in foreign exchange markets by selling New Zealand dollars. This would address the real nub of the Reserve Bank's current problem – that the exchange rate refuses to fall even as export conditions are deteriorating. The RBNZ has often mentioned that it would prefer a different mix of monetary conditions, involving higher interest rates to restrain the housing market and a lower exchange rate.

The RBNZ has four formal criteria for currency intervention. (1) The exchange rate must be extreme; (2) it must be unjustified; (3) intervention must be consistent with the aims of monetary policy; and (4) intervention must be opportune (ie, it would work). We would add an informal fifth condition that intervention has to have a decent chance of proving profitable in the long run.

We would argue that the first three formal conditions have long been satisfied, as has the informal fifth condition. However, the requirement that intervention would actually work has been doubtful. Selling New Zealand dollars today and then hiking the OCR next week would certainly be intervention harakiri. But once the RBNZ officially pauses its OCR hiking cycle, opportune moments could arise. For example, if market positioning comes to suggest that the New Zealand dollar is vulnerable to a fall, the RBNZ might well take the opportunity to intervene and so catalyse a fall.

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

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.