Westpac

Institutional Bank

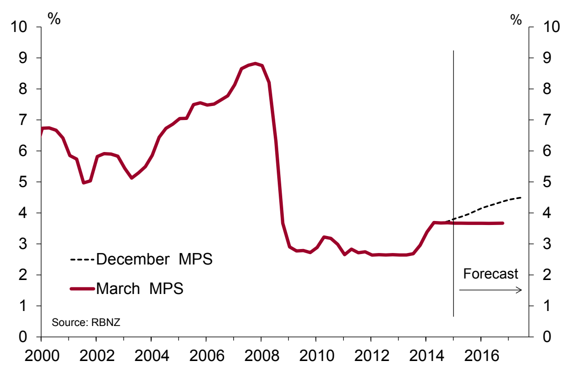
12 March 2015

Keep it simple

March 2015 MPS Review: OCR unchanged at 3.5%

- The Reserve Bank left the OCR unchanged at 3.50% and signalled that it has no plans to move the OCR in either direction for the foreseeable future.
- The Monetary Policy Statement (MPS) was squarely aimed at guiding markets towards this view, with a dead flat (and shortened) projection for 90-day interest rates.
- The outlook for the domestic economy remains robust.
- However, persistently lower than expected inflation remains a bugbear, and the RBNZ acknowledged that a sustained fall in wage and price expectations could warrant lower interest rates.
- Despite this concession, those looking for the RBNZ to adopt an easing bias today will have been disappointed.
- We see no reason to alter our forecast for no change in the OCR all year.

RBNZ 90-day interest rate forecasts



Today's *Monetary Policy Statement* was both more and less complex than we've come to expect from the Reserve Bank in recent times. More complex due to the growing number of conflicting considerations for monetary policy, as reflected in the increased length of the document itself. But less complex in terms of the 'bottom line' message delivered to the market.

The RBNZ largely retained the language of its January OCR review, where it adopted a neutral stance on interest rates, and backed it up this time by drawing a flat line interest rate projection for the next couple of years. We'll have more to say about that interest rate track shortly, but the message intended for markets was clear enough: the RBNZ has no plans to move interest rates, in either direction, for the foreseeable future.

Today's statement will have disappointed the sizeable portion of the market that is clamouring for interest rate cuts. Hence the subsequent market reaction: although interest rates were little changed, the NZ dollar initially spiked a cent higher after the statement. That will hardly please the RBNZ, given that today's statement if anything escalated the language around the strength of the exchange rate. However, we suspect the move reflects a clean-out of speculative positions rather than a change in the market's view on the currency.

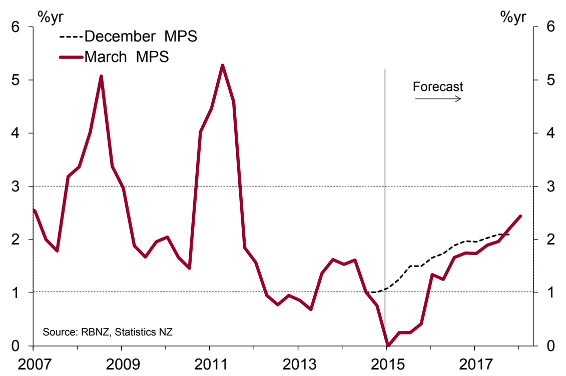
The RBNZ's overall assessment was similar to the one made in the January OCR review and Governor Wheeler's follow-up speech in January. That's no surprise given the lack of major developments since then. The key policy guidance paragraph of today's statement effectively repeated the language used in January:

"Our central projection is consistent with a period of stability in the OCR. Future interest rate adjustments, either up or down, will depend on the emerging flow of economic data."

However, the details of the *Monetary Policy Statement* suggest a more conscious effort to guide market pricing along these lines. Not only was the 90-day interest rate projection dead flat at current levels, it was deliberately cut off a year earlier than the other economic forecasts, ending at March 2017.

It's not hard to deduce that that additional year would have included an uptick in interest rates, given the details elsewhere in the document. The RBNZ has long been upbeat on the domestic economy, and has revised up its GDP growth forecasts even further, notwithstanding a temporary blip early this year due to drought. By 2017 the economy is expected to be running even further ahead of its non-inflationary potential than previously thought. Inflation is expected to rise above the 2% target midpoint by the end of 2017, partly due to an assumed rebound in oil prices but also partly due to stronger non-tradable inflation pressures. And the RBNZ has not changed its assessment of the long-run 'neutral' interest rate – it's still at 4.5%, around 80 basis points north of the current level.

Inflation forecasts



The reason given for truncating the interest rate track was to prevent financial markets overreacting to a small projected uptick in interest rates, occurring at a long and highly uncertain time horizon. In particular, were the market to start pricing in interest rate hikes in the mistaken belief that the RBNZ held a near-term hiking bias, the exchange rate would rise – a prospect that the RBNZ would be very uncomfortable with. Instead, the RBNZ stuck to its knitting and emphasised the bit it feels strongly about – the OCR is currently expected to remain unchanged for the coming two years.

An important factor behind the RBNZ's firmly neutral stance – and perhaps a point of difference with other central banks – is its approach to oil prices. The sharp drop in oil prices in recent months is expected to keep annual inflation close to zero for the next year, while at the same time leaving more money in the pockets of consumers and businesses. Tracing the economic impacts of the fall in oil prices warranted a whole chapter in the *MPS* itself, but the RBNZ was up-front and clear about the bottom line for interest rates:

"Monetary policy is not responding to the direct, near-term effects on inflation of the fall in the oil price level of the past six months, nor will it respond to the direct effects of the rise in oil prices assumed in the projection for 2017. This is because monetary policy affects inflation with a lag and cannot offset these effects – trying to do so would result in unnecessary instability in output, interest rates and the exchange rate."

The RBNZ is still uncomfortable with the strength of the exchange rate – while the NZ dollar has fallen quite a bit against the US dollar, it remains at a very high level in trade-weighted terms. If anything, the language in today's statement escalated those concerns: the January statement noted that a further significant depreciation was "expected", today's statement said that it was "needed" in order to rebalance New Zealand's external accounts.

The chief risk of the RBNZ's mind surrounds inflation expectations. The MPS contained an alternative scenario in which recent falls in oil prices affect wage- and price-setting behaviour to a greater degree than expected, and inflation expectations fall from their current level of around 2% to 1%. In this case, the RBNZ indicated it would cut the OCR by around 50 basis points. While this is a plausible scenario, it would take a long time to play out; we don't think it offers any encouragement to those betting on interest rate cuts in the near future.

There was no mention of macroprudential policy, or the recent consultation on increased bank capital requirements for investor property loans. That's not surprising, as the RBNZ tends to avoid conflating these issues with monetary policy. Indeed, there was no mention at all of housing as a concern for monetary policy, even though the RBNZ have acknowledged the market's recent resurgence. The RBNZ now expects house price inflation to accelerate to 7.4% this year (much the same as our forecast), and has significantly upgraded its forecasts of household spending as well.

Our forecast remains for interest rate hikes to resume around the middle of next year. However, as we've said before, further interest rate hikes are such a distant prospect at the moment that debating the timing is something of a red herring. The overarching view, one that we share with the RBNZ, is that persistently low inflation, despite a strong domestic economy, has muddied the waters for monetary policy. Until we get some clarity on the medium-term outlook for inflation, we agree with the RBNZ that there is no case for moving the OCR one way or another.

Dominick Stephens
Chief Economist

Michael Gordon
Senior 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.