

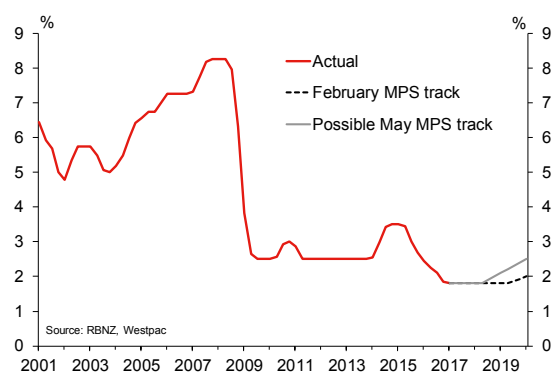
# A new challenge

## Preview of RBNZ Monetary Policy Statement, 11 May

5 May 2017

- We expect the Reserve Bank to hold the OCR at 1.75% next week, but with a stronger signal that the next move in interest rates will be up.
- Inflation is now close to the 2% target midpoint, though partly due to some temporary factors that are likely to fade over the next year.
- The challenge for the RBNZ now is to keep inflation on target over the medium term.
- The economy is growing steadily, but not at a pace that suggests the RBNZ needs to hit the brakes.
- And higher mortgage rates have already had a noticeable impact on house prices and consumer spending.

RBNZ OCR projection



Next Thursday's Monetary Policy Statement will address a challenge that the Reserve Bank hasn't faced in many years: not how to return inflation to the target, but how to keep it there. Headline inflation has reached the 2% mark much sooner than expected, though partly due to some temporary factors that will wane over the coming year. Still, measures of underlying inflation have also been picking up for the last year or so, which suggests that the RBNZ will need to move away from the current loose monetary policy settings at some point.

The question is how soon the RBNZ will take that step. If there were reason to think that inflation could accelerate further and threaten the upper end of the 1-3% target range, there would be a case for raising the OCR now. Instead, our view – one that we think the RBNZ will come to as well – is that inflation is likely to hold around the 2% mark for the next year or so. There's little sign that the economy is at risk of overheating, and there are still some headwinds to a further pickup in inflation over coming years.

Nevertheless, the RBNZ will have to acknowledge how conditions have changed in the last three months. The February MPS and the March OCR review both concluded that "monetary policy will remain accommodative for a considerable period", and the RBNZ's projections suggested that the OCR could remain on hold until late 2019. With inflation picking up sooner than expected, that no longer seems like a tenable forecast. We expect the bottom line in next week's statement to be more along the lines of:

"Monetary policy will continue to be accommodative, to ensure that medium-term inflation remains near the 2 percent midpoint of the Reserve Bank's target range."

We expect the RBNZ's interest rate projections to be more consistent with an OCR hike by late 2018. This would probably be neutral for financial markets on the day: an earlier start than previously signalled, but stopping short of endorsing market pricing for a hike by March next year.

### Details

In a speech in March, RBNZ Governor Wheeler concluded that the risks around the OCR were evenly balanced, with downside risks from the global environment but upside risks from the domestic economy. In particular, the Governor emphasised the uncertainty around the Trump

administration's policies, and the risk of a marked rise in trade protectionism.

The RBNZ's concerns about the global backdrop will probably remain. Forecasts of world growth have generally been revised up in recent months, but inflation (setting aside the rebound in oil prices over the last year) remains subdued. Moreover, US government policy is perhaps even more worrying now – the odds of a large fiscal stimulus in the near term are growing dimmer, while the risk of a wave of trade protectionism is very much at the forefront.

On the domestic front, the biggest development for the RBNZ is that inflation has risen much quicker than the RBNZ expected. After lingering at near-zero levels for much of the last two years, annual inflation rose to 2.2% in the March quarter – well ahead of the RBNZ's forecast of 1.5%, and a level that it hadn't expected to see for several more years.

Some of the surprise will have been due to developments since that forecast was made in early February, such as a weather-related spike in fruit and vegetable prices and a rise in fuel prices. The RBNZ had already braced itself for this outcome to some degree – in its March OCR review it noted that “headline CPI will be variable over the next 12 months due to one-off effects”. However, the more domestically-driven components of the CPI also turned out a bit stronger than the RBNZ expected, and price rises in these areas tend to be more persistent.

On top of this, the New Zealand dollar is about 4% lower than the RBNZ projected in February, which will add to its forecast of tradables inflation over the next year at least. And the rebound in dairy prices over the second half of 2016 has proven to be more enduring than the RBNZ had assumed.

The outlook for medium-term inflation, however, is less straightforward. Fuel prices have now passed their peak impact on annual inflation – the 80% rise in crude oil prices between February 2016 and February 2017 is unlikely to be repeated – and food prices will have returned to normal by next year. So we wouldn't be surprised if inflation is back below the 2% mark through much of 2018.

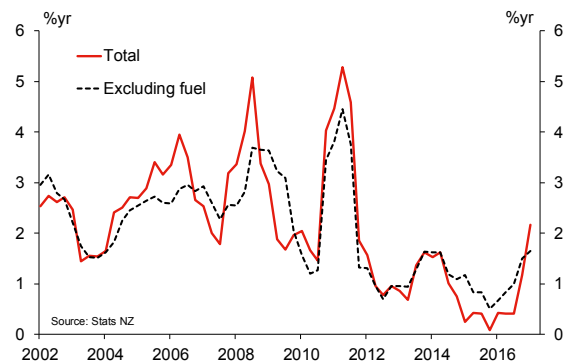
The economy is growing at a solid pace, but much of this is a reflection of population growth. Per-capita GDP growth is running at about 1% a year, not particularly high by historic standards. The unemployment rate of 4.9% is still above most estimates of the 'natural' rate, and the absence of any pickup in wage growth also suggests that the labour market still has some slack.

Finally, the housing market is proving to be a double-edged sword. House price growth has slowed sharply since August, and has flattened out completely in previous hotspots such as Auckland and Tauranga. Loan-to-value limits for property investors were tightened further in July, and – more importantly in our view – mortgage rates have risen in recent months. To date the RBNZ has treated the housing slowdown as temporary, “given the continued imbalance between supply and demand”. But the evidence is now too strong to dismiss.

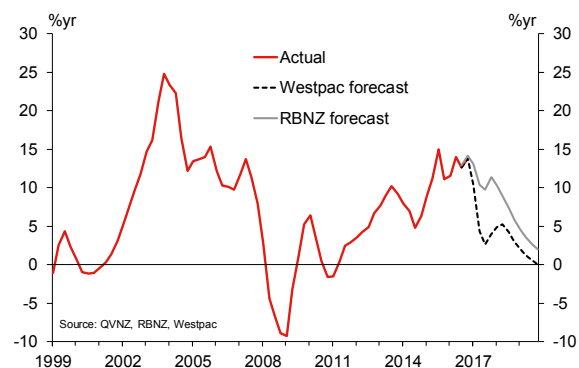
While the RBNZ may be pleased to see a cooling in the housing market from a financial stability perspective, it presents a real challenge on the monetary policy side. The RBNZ's forecasts have relied on strong household spending, supported by rising house prices, to drive economic growth and a lift in domestic inflation. In February the RBNZ forecast an 11% rise in house prices this year; so far it's tracking in the low single digits. And that already seems to be having an impact on consumer spending – for instance, card spending on durable goods has fallen in five of the last six months.

With inflation back on track earlier than expected, the RBNZ will no doubt be weighing up when it can start 'normalising' interest rate settings. But we're wary that signalling too much in the way of rate hikes at this stage could push retail interest rates and the exchange rate higher, undermining the growth that the RBNZ is relying on to meet its inflation target.

### CPI inflation



### House price forecasts



### Michael Gordon

Acting Chief Economist

---

# Contact the Westpac economics team

---

**Michael Gordon**, Acting Chief Economist +64 9 336 5670

**Satish Ranchhod**, Senior Economist +64 9 336 5668

**Sarah Drought**, Economist +64 9 336 5696

**Shyamal Maharaj**, Economist +64 9 336 5669

**Any questions email:** [economics@westpac.co.nz](mailto:economics@westpac.co.nz)

Past performance is not a reliable indicator of future performance. The forecasts given in this document 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.

---

## Disclaimer

---

### Things you should know

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141 ('Westpac').

### Disclaimer

This material contains general commentary, and market colour. The material 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 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 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. 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.

### Country disclosures

**Australia:** Westpac holds an Australian Financial Services Licence (No. 233714). This material is provided to you solely for your own use and in your capacity as a wholesale client of Westpac.

**New Zealand:** In New Zealand, Westpac Institutional Bank refers to the brand under which products and services are provided by either

Westpac or Westpac New Zealand Limited ("WNZL"). Any product or service made available by WNZL does not represent an offer from Westpac or any of its subsidiaries (other than WNZL). Neither Westpac nor its other subsidiaries guarantee or otherwise support the performance of WNZL in respect of any such product. The current disclosure statements for the New Zealand branch of Westpac and WNZL can be obtained at the internet address [www.westpac.co.nz](http://www.westpac.co.nz). 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:** This material has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (as defined in the applicable Singapore laws and regulations) only. Recipients in Singapore of this material should contact Westpac Singapore Branch in respect of any matters arising from, or in connection with, this material. 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 licence 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 activities. This material is intended only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance. 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.

**UK:** The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the

---

# Disclaimer continued

---

Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. 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 communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication 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 communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

## Investment Recommendations Disclosure

The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner. Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

- (i) Chinese Wall/Cell arrangements;
- (ii) physical separation of various Business/Support Units;
- (iii) and well defined wall/cell crossing procedures;
- (iv) a "need to know" policy;
- (v) documented and well defined procedures for dealing with conflicts of interest;
- (vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

**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.