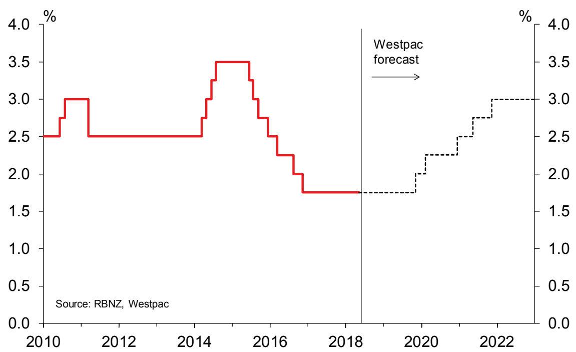
Red herring

RBNZ OCR Preview, June 2018

Dominick Stephens, Chief Economist +64 9 336 5671

- We expect the RBNZ to repeat its main message that the OCR is expected to remain on hold for a long while, but the timing and direction of the next move will depend on how the economy evolves.
- Markets are fixated on whether the RBNZ will repeat the words "up or down" used in its last policy guidance paragraph.
- That is a red herring. The RBNZ may well choose different words to express its on hold stance, and might even choose words other than "up or down." This would not necessarily constitute a signal that the OCR outlook has changed.
- The RBNZ is keen to avoid formulaic communications, and might chop and change its wording even if its intentions have not changed.
- Markets will need to assess the actual meaning of the RBNZ's press release, rather than mechanically reacting to changes in wording.
- Beneath the policy guidance paragraph, the details of the press release might be slightly more hawkish than the May statement.

Westpac OCR forecast



Chop and change

After last month delivering his first Monetary Policy Statement (MPS) as RBNZ Governor, next week Adrian Orr will deliver his first OCR Review. OCR Reviews are parsimonious affairs compared to MPSs – there is no booklet, no published forecast, and no press conference, just a simple one-page press release.

Back in May, the RBNZ's key policy guidance paragraph was:

"The Official Cash Rate (OCR) will remain at 1.75 percent for some time to come. The direction of our next move is equally balanced, up or down. Only time and events will tell"

Markets latched onto the "up or down" comment, which hadn't appeared in previous guidance paragraphs. They judged this a sign that the RBNZ was becoming more dovish. Markets will be intensely interested to see if that comment is repeated next week.

We are less convinced that the "up or down" comment signalled a change in view from the Reserve Bank. More likely, it simply reflected the new Governor's more forthright communication style. The remaining content of the MPS was a continuation of previous messages, and the RBNZ's OCR forecast was almost identical to the forecasts issued earlier in the year.

Next week, we expect the Reserve Bank's policy guidance paragraph will once-again say that the OCR is firmly on hold and is expected to remain on hold for a long while yet, depending on how the economy evolves. However, the details beneath the policy guidance paragraph may be a touch more hawkish than the May details.

Even though we expect the that the RBNZ will want to continue with the same basic "on hold" message, we do not necessarily expect that the policy guidance paragraph will be worded the same as it was in May. Instead, the RBNZ might choose different words to convey the same meaning. The RBNZ is trying to avoid formulaic communications. It wants markets to read each statement individually, rather than making side-by-side comparisons between the exact wording of two statements. This means that, unlike most central banks, the RBNZ might change the wording of its policy guidance paragraph even if its views have not changed.

For next week, the policy guidance paragraph might or might not contain the words "up or down." But whether or not these particular words are included is not important – it is the overall meaning that we must pay attention to, not the choice of words. Markets will need to be very cautious about knee-jerk reactions when the statement is released – it is easy to imagine a scenario where the words "up or down" are excluded and markets react strongly, only for that reaction to reverse later when analysts realise that the RBNZ is still firmly on hold.

Beneath the headline

While the policy guidance paragraph may repeat the same "on hold" message, we suspect that the content of the RBNZ's press release could carry a slightly more hawkish tone than the May MPS. Most likely, this will come through in the details that are discussed in the body of the press release.

For some time, the RBNZ's key message has been that inflation is currently lower than it would like, but strong economic growth is set to push inflation up to 2% in time. Meanwhile, employment is seen as being in line with the "maximum sustainable level." The RBNZ has felt that the OCR must be kept low to support an increase in inflation, but not so low as to create unnecessary volatility, including pushing employment beyond the maximum sustainable level. Hence, the RBNZ has concluded that keeping the OCR at the current level for a long while is the best course.

Over the past six weeks there have been three key developments with the potential to alter the outlook – two on the upside for inflation, one on the downside:

- Petrol prices have risen sharply. This is likely to cause inflation to rise to 2%, or even beyond, this year. The RBNZ will emphasise that petrol prices tend to have a fleeting effect on inflation, and that it will keep its eye on core inflation which remains well below 2%.
- The economy is slowing instead of accelerating as the RBNZ had long expected. GDP growth in the March quarter was 0.5%, instead of the 0.7% the RBNZ forecast in May. This is the sixth consecutive quarter in which GDP growth has been lower than the RBNZ forecast. The RBNZ has long held very bullish expectations for 2018 that are simply not panning out – at one point the RBNZ's quarterly GDP growth forecast for March 2018 was 1.2%.
- The Government's Budget was stimulatory. Government spending is now expected to have an even larger impact on aggregate demand in the early-2020s than the RBNZ previously allowed for, meaning less need for monetary policy to support the economy over that timeframe. Hence the stimulatory Budget, on its own, will allow the RBNZ to lift its OCR forecast a little.

The balance of these developments is slightly to the upside. The RBNZ will not publish an OCR forecast next week. But its internal OCR forecasts may be slightly higher than they were in May. This is probably not enough to change the RBNZ's overall strategy, but that slight tilt higher in the balance of risks might come through in the details of the OCR Review.

Dominick Stephens
Chief Economist

Contact the Westpac economics team

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, Economist +64 9 336 5669

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: 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. 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: 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 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 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 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.