

Hold the horses

OCR preview, July 2013

- **We expect the RBNZ to retain its “firmly on hold” stance.**
- **The RBNZ is unlikely to announce LVR restrictions on Thursday.**
- **Markets are looking for signs of early hikes, but may be disappointed.**
- **We believe the RBNZ will eventually shift to a more hawkish stance, but now is not the time.**

Markets are champing at the bit to price in OCR hikes. The RBNZ may want to move in the same direction, but not as eagerly as markets. So Thursday’s OCR review may be an exercise in reigning in expectations.

For a long while the Reserve Bank has been stuck between a rock and a hard place. The improving economy portends future inflationary pressures, but in the near term the very high exchange rate has suppressed inflation. The RBNZ has navigated a middle course, signalling that it expects to keep the OCR unchanged this year before the barest of OCR hiking cycles is initiated in 2014.

Market pricing roughly agreed with the RBNZ’s message until a few weeks ago. But a radical change in sentiment has seen markets move to price in three OCR hikes by the end of next year.

There were two catalysts for the market’s lurch in a hawkish direction. The New Zealand dollar dropped against the US dollar, and a swathe of data showed the New Zealand economy is firmly in the grip of an economic upturn.

To be sure, these are important developments and they will influence the Reserve Bank’s thinking to some extent. But central bankers are a cautious bunch, and are unlikely to leap to any conclusion as rapidly as markets have. What’s more, there are a few considerations that will take the gloss off the case for early OCR hikes in the RBNZ’s mind.

First, the fall in the exchange rate is not so significant when viewed through a trade-weighted lens. The kiwi has actually strengthened against the Australian dollar, such that the trade weighted index is only 4% lower than the RBNZ projected in the June *Monetary Policy Statement*. On Thursday the RBNZ will presumably acknowledge the fall in the TWI, but will probably also complain that the exchange rate remains overvalued.

Second, fixed mortgage rates have risen between 15 and 25 basis points in recent weeks. This will weigh on the housing market, thereby reducing the need for the Reserve Bank to raise the OCR.

And finally, it is worth bearing in mind that most economists, Reserve Bank included, have long been anticipating a period of elevated economic growth associated with the Canterbury rebuild. The fact that this growth has now arrived is not cause for the Reserve Bank to alter its expectations for future monetary policy.

So we expect Thursday’s OCR review will hew closely to the wording of previous statements. The RBNZ will probably repeat that it expects *“GDP growth to accelerate to about 3.5 percent by the second half of 2014, and inflation to rise towards the midpoint of the 1 to 3 percent target band.”* We firmly expect the RBNZ will repeat its bottom-line OCR guidance of *“we expect to keep the OCR unchanged through the end of the year”*.

While the Reserve Bank is holding the line on interest rates, there are changes afoot in its financial stability role. The RBNZ is concerned that rising house prices pose a financial stability risk, and has clearly signalled its intention to place limits on high loan-to-value ratio (LVR) lending in the near future. However, Thursday is not the time to announce LVR restrictions or even to provide details – OCR reviews are about the OCR. That said, the RBNZ will probably repeat the observation it has made at each OCR review this year: *“The Bank does not want to see financial stability or inflation risks accentuated by housing demand getting too far ahead of supply”*.

Market implications

We expect the RBNZ will give no encouragement to the idea that the OCR could be hiked this year or early next year. If that is correct, interest rates and the NZD will fall slightly after the OCR review. However, markets will almost certainly persist in pricing more OCR hikes than the RBNZ is officially forecasting, and with good reason. Westpac’s view is that the RBNZ will eventually have to shift to a more hawkish stance, as the Canterbury rebuild proves inflationary. But Thursday is not the time to announce such a change in stance.

Dominick Stephens
Chief Economist

Westpac Economics Team Contact Details

Dominick Stephens , Chief Economist	Ph: (64-9) 336 5671	dominick_stephens@westpac.co.nz
Michael Gordon , Senior Economist	Ph: (64-9) 336 5670	michael_gordon@westpac.co.nz
Felix Delbrück , Senior Economist	Ph: (64-9) 336 5668	felix_delbruck@westpac.co.nz
Nathan Penny , Economist	Ph: (64-9) 336 5669	nathan_penny@westpac.co.nz

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. 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. 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.

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.