

# Now that's more like it

## OCR review, July 2013

- **The Reserve Bank has shifted to an explicit hiking bias, its first significant change of stance since December 2011.**
- **The RBNZ is becoming more concerned about the inflation consequences of rising house prices and the construction boom.**
- **This fits with our views. We expect the OCR hiking cycle will begin in March 2014 and peak at 5.5%.**

The RBNZ today announced a significant change in the stance of monetary policy. From December 2011 until June 2013 the RBNZ had maintained an “on hold” bias in the text of its OCR reviews and Monetary Policy Statements. Today the final sentence of the OCR review introduced an explicit tightening bias, although hiking the OCR this year was ruled out:

*“Although the removal of monetary stimulus will likely be needed in the future, we expect the keep the OCR unchanged through the end of this year.”*

It seems the RBNZ now expects to hike the OCR in early, rather than late, 2014.

Compared to previous OCR reviews, the RBNZ has become slightly more bullish on the New Zealand economy, noting that the upturn had become “more widespread”. The RBNZ’s concern about the high New Zealand dollar was also downgraded following the drop below 80c against the US dollar, though only slightly. The exchange rate is now described as “high” rather than “overvalued”.

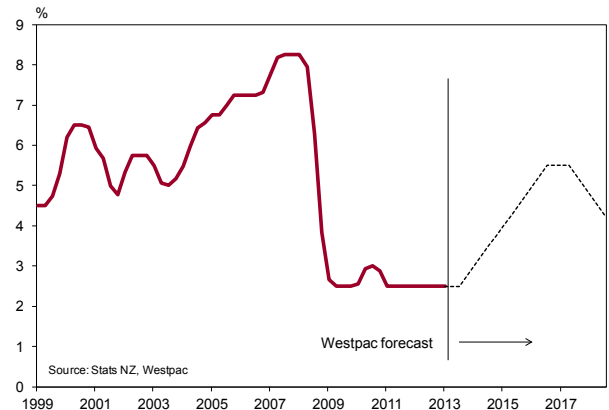
But the real motivation for the RBNZ’s change in stance came in the paragraphs concerning inflation. The RBNZ has long signalled that it expects inflation to gradually rise towards 2%. But for the first time in a long while, the expected increase in inflation was linked to rising house prices and the construction boom.

There is an important back-story here. Some time ago the Reserve Bank adopted explicit assumptions that rising house prices would not provoke much extra consumer spending, and that the Canterbury rebuild would prove less inflationary than historical construction booms. Based on those assumptions, the RBNZ felt that the OCR could be maintained at a very low level for years without jeopardising its 2% inflation target. It forecast the OCR to remain below 4% until 2016.

The subtext was always clear. Should the assumptions be disproven, the outlook for the OCR would have to be revised.

Westpac disagreed with these sanguine assumptions on consumer spending and construction-related inflation from the outset.

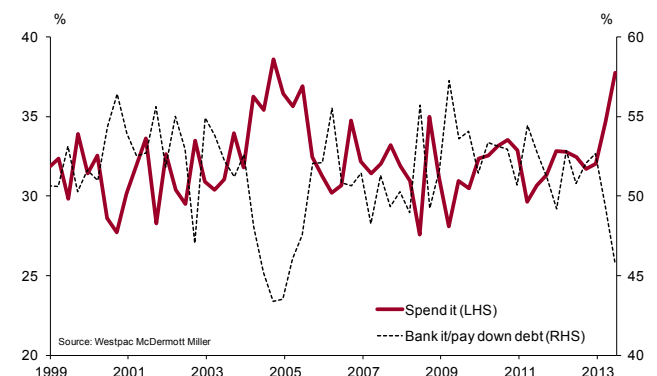
**Westpac’s OCR forecast**



We saw no compelling reasons that this cycle would be different to past housing and construction booms. Consequently, our own forecasts incorporated the idea that households would spend up on the back of rising house prices, and that the construction boom would provoke inflation pressures.

The jury was out on these questions until just a few months ago. This is no longer the case. Very clear evidence in favour of consumer spending has emerged. For example, the proportion of households in the Westpac McDermott Millar Consumer Confidence Index saying they would spend rather than save a \$10,000 windfall jumped sharply over the first half of this year. Household borrowing is now growing comfortably faster than national income. So is retail spending.

**How would you spend a \$10,000 windfall?**



As for construction-related inflation, until recently this was strictly contained to the Canterbury region and inflation was low on all fronts. But evidence of widespread construction-related inflation clearly emerged in the June quarter Consumer Price Index figures, released last week.

Indeed, we actually thought the RBNZ would mull this evidence a little longer before changing stance, so we were slightly surprised by the hawkishness of today's OCR review.

As for how the RBNZ intends to react to these putative inflationary pressures, the penultimate sentence of the OCR review was crystal clear:

*“The extent of the monetary policy response will depend largely on the degree to which the growing momentum in the housing market and construction sector spills over into inflation pressures.”*

All this supports our view that the first OCR hike will come in March 2014, and the OCR will rise to 5.5% by the end of 2016.

### **The next chapter**

Even as some issues are becoming clearer, new uncertainties around monetary policy are emerging.

The first is the trajectory of the exchange rate. The New Zealand dollar has fallen against the US dollar because the US Federal Reserve has issued a signal that it intends to “taper” the pace of quantitative easing (slow the rate of money-printing). If the Fed does taper, the New Zealand dollar could fall further. This would push up prices for imported goods and services, requiring early OCR hikes. But the Fed's tapering signal was conditional on US data remaining strong, and on that front we are doubtful. If our doubts are vindicated the New Zealand dollar will strengthen again, thus reducing the need for OCR hikes.

The second uncertainty is the RBNZ's intention to invoke speed limits on banks' ability to lend at high loan-to-value ratios (LVRs). Nobody can be certain of how LVR restrictions will affect the housing market. Our tentative view is that house prices will continue marching higher as investor demand supports prices. So on that front we remain of the view that OCR hikes are necessary.

### **Market reaction**

Markets were positioned for an unchanged review, so the reaction has been to send interest rates and the exchange rate higher. So far the 2-year swap rate has risen 8bp to 3.30%, and the exchange rate has risen half a cent against the US dollar. We suspect that market reaction will continue in the same direction throughout the day.

Markets are now pricing in a full OCR hike for March 2014, and further hikes over the course of 2014. We agree with that.

### **Full RBNZ statement**

The Reserve Bank today left the Official Cash Rate (OCR) unchanged at 2.5 percent.

Reserve Bank Governor Graeme Wheeler said: “The global outlook remains mixed, with the euro area still in recession and signs of slower growth in China and Australia, but more positive recent indicators in the United States and Japan. Global debt markets have become more cautious due to uncertainty around the Federal Reserve's anticipated exit from quantitative easing.

“Growth in the New Zealand economy is picking up and, although uneven, is becoming more widespread across sectors. Consumption is increasing and reconstruction in Canterbury will be reinforced by a broader national recovery in construction activity, particularly in Auckland. This will support aggregate activity and eventually help to ease the housing shortage.

“In the meantime rapid house price inflation persists in Auckland and Canterbury. As previously noted, the Reserve Bank does not want to see financial or price stability compromised by housing demand getting too far ahead of the supply response.

“Despite having fallen on a trade-weighted basis since May 2013, the New Zealand dollar remains high and continues to be a headwind for the tradables sector, restricting export earnings and encouraging demand for imports. Fiscal consolidation will weigh on aggregate demand over the projection horizon.

“CPI inflation has been very low over the past year, reflecting the high New Zealand dollar and strong international and domestic competition. However, inflation is expected to trend upwards towards the mid-point of the 1-3 percent target band as growth accelerates over the coming year.

“The extent of the monetary policy response will depend largely on the degree to which the growing momentum in the housing market and construction sector spills over into inflation pressures.

“Although removal of monetary stimulus will likely be needed in the future, we expect to keep the OCR unchanged through the end of the year.”

### **Dominick Stephens**

Chief Economist

## Westpac Economics Team Contact Details

<b>Dominick Stephens</b> , Chief Economist	Ph: (64-9) 336 5671	dominick_stephens@westpac.co.nz
<b>Michael Gordon</b> , Senior Economist	Ph: (64-9) 336 5670	michael_gordon@westpac.co.nz
<b>Felix Delbrück</b> , Senior Economist	Ph: (64-9) 336 5668	felix_delbruck@westpac.co.nz
<b>Nathan Penny</b> , 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](http://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](http://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](http://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.