Westpac

Institutional Bank

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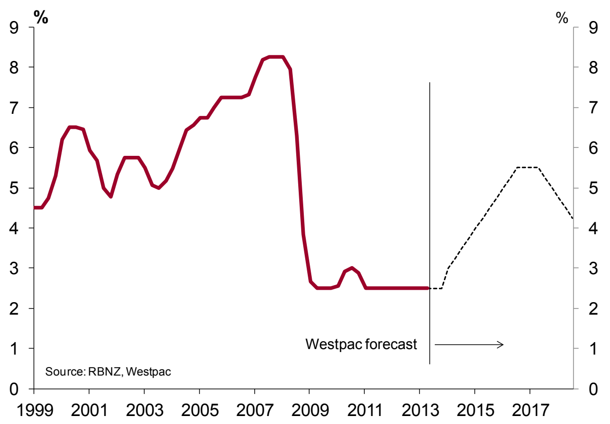
Straight bat

December 2013 Monetary Policy Statement Preview

- We expect the December *MPS* will repeat the RBNZ's previous message that the OCR is going up, but not until around April.
- The RBNZ will acknowledge that the balance of conditions has changed – the economy is stronger, but the exchange rate is higher than previously anticipated.
- Markets are flirting with the idea of a January hike, but would be discouraged by a statement along the lines that we expect.
- We expect the first OCR hike will occur in April 2014.

RBNZ 90-day rate forecast



We expect next week's *Monetary Policy Statement* will be a "straight bat" affair that reiterates the RBNZ's previous messages.

First and foremost, the RBNZ will be looking to confirm the basic message that interest rates are going to rise next year.

We also expect the RBNZ will reaffirm the indicative timing of next year's OCR hikes. Previous communications have indicated that the RBNZ is targeting April as the date of the first OCR hike. We expect that message to be repeated next week. The economy may be strong, but the new high-LVR mortgage restrictions are too fresh, and the exchange rate too high, for the RBNZ to contemplate hiking the OCR earlier than previously advertised.

If our expectations are met, financial markets will be disappointed. Short-term interest rates and the exchange rate would fall on the day. Financial market pricing is consistent with the first OCR hike occurring in either January or March next year. But if the RBNZ has either of those dates in mind, it will have to alter its communications and send a strong signal next week that OCR hikes are imminent. We don't think any such signal will be forthcoming.

The story to date

Before explaining our reasoning, we will start with a brief recap of the Reserve Bank's recent communications. The bottom line of the September *MPS* was that OCR hikes "will likely be required next year", with the timing and extent of hikes dependent "on the degree to which the momentum in the housing market and construction sector spills over into broader demand and inflation pressures." The accompanying forecasts were gung-ho on the New Zealand economy, featuring 2.5% per quarter house price inflation and 1% GDP growth into early 2014, along with an aggressive decline in unemployment. The exchange rate had dropped in the months before the September *MPS*, and the RBNZ expressed a certain degree of comfort about that. The overall message was that with the exchange rate down and the economy strong, the OCR would start rising from around April 2014.

The best laid plans...

The plan the Reserve Bank laid out back in September was admirably clear. But it started going awry almost as soon as it was laid out. Five days after the *MPS* was delivered, the Federal Reserve shocked financial markets by not tapering its quantitative easing programme. The New Zealand dollar soared.

It seems the Reserve Bank was as shocked as anybody about the no-taper decision. The October OCR Review was similar to the September MPS, except that it contained a new paragraph explaining that sustained strength in the exchange rate could affect the timing and magnitude of OCR hikes. We took this to mean that if the exchange rate stayed high and nothing else changed, OCR hikes would be delayed beyond April. Graeme Wheeler also gave newspaper interviews in late October and early November in which he expressed his surprise at the Fed's no-taper decision. He said he had been hoping that Fed tapering would enable the RBNZ "to tighten monetary policy from a position of a lower exchange rate." By implication, the renewed strength of the exchange rate would make hiking the OCR more difficult.

The Reserve Bank has sent as clear a message as any – with the exchange rate higher than anticipated, all else equal the RBNZ will become more reluctant to hike the OCR.

But isn't the Kiwi economy super-strong?

Of course, all else is never equal. The New Zealand economy has gone from strength to strength in recent months, to the point where we are forecasting 1.4% GDP growth for the September 2013 quarter. The global economy is looking less risk-laden than a few months ago. New Zealand's terms of trade have hit a 40-year high. And there are now a few signs of inflation pressures beginning to emerge.

However, when it issued the September *MPS* the Reserve Bank had already factored in the idea that the economy would strengthen and inflation would rise. Relative to those expectations, the economy, inflation, and terms of trade are probably only a little stronger than the RBNZ anticipated.

The housing market: a non-issue this time

The last issue surrounding next week's *MPS,* the housing market, is a bit of a non-issue. The RBNZ has already factored in the idea that the new restrictions on mortgage lending will slow the housing market, thereby slowing the economy a little and reducing the need for OCR hikes. If the actual impact of the mortgage restrictions is different to expectations, then obviously the OCR outlook will have to change. However, at this stage it is far too early to tell what the actual impact of the mortgage restrictions has been. There is no reason to expect the RBNZ will deviate from its previous views on this question.

Boiling it all down

When we boil it all down, the Reserve Bank is faced with both stronger economic conditions and a higher exchange rate than previously anticipated. Those two surprises roughly offset one another, so we conclude that next week's *Monetary Policy Statement* will convey a similar overall intent to the September *MPS*.

The 90-day interest rate forecast contained within the *MPS* document may be similar to, or perhaps slightly higher than, the forecast that was issued back in September.

The text of next week's *MPS* will have to acknowledge both the stronger economy and the higher exchange rate relative to previous expectations, and will have to discuss the impact of both developments on inflation.

The final paragraph of the press release usually conveys the bottom line outlook for monetary policy. For most of this year, it has emphasised that the RBNZ expects to keep the OCR unchanged in 2013. That comment is redundant now, and will be purged from next week's press release. We think the idea of the new "bottom line" will be to preserve flexibility, and could look something like:

"OCR increases will likely be required next year. The extent and timing of the rise in the policy rate will depend on the degree to which the momentum in the housing market and construction sector spills over into broader demand and inflation pressures, and on the evolution of the exchange rate."

Such a statement would offer no encouragement to the notion of a January OCR hike. The lack of any firm guidance from the RBNZ that OCR hikes were imminent would cause financial markets to reduce the odds on a January move, causing a drop in short-term interest rates on the day.

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