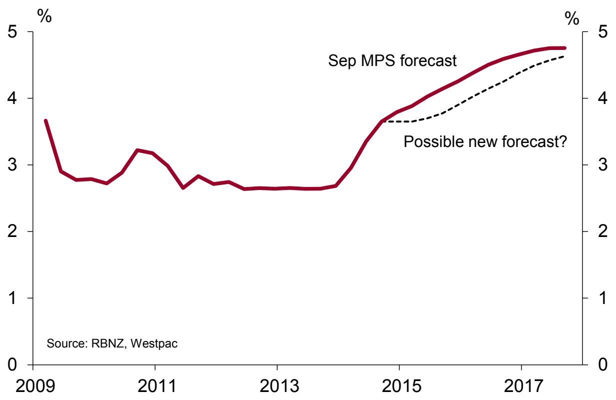
Westpac
Institutional Bank

For the sake of clarity
December 2014 *MPS* preview

- The December *MPS* should serve to clear up market confusion about the RBNZ's current thinking.
- The overall tone will be similar to the October OCR Review.
- The RBNZ intends to leave the OCR on hold for the time being, but expects to increase interest rates over the years ahead.
- The *MPS* is likely to discuss the causes and consequences of low inflation.
- The RBNZ's 90-day interest rate forecast may be around 30bp lower than the forecast issued in September, and will suggest no hike until late 2015.
- On the exchange rate, the RBNZ will keep beating the "unjustified and unsustainable" drum.

Reserve Bank forecasts of 90-day interest rates



Next week the Reserve Bank will deliver its final *Monetary Policy Statement* for the year, and is universally expected to leave the OCR unchanged at 3.5%. We think the Reserve Bank will be aiming to deliver three simple messages in its communications on the day:

- Inflation is currently very low, but is expected to rise eventually.
- The OCR is firmly on hold for now, but is expected to rise eventually.
- The exchange rate is too high.

These basic messages will be reflected in the press release, the text of the *Monetary Policy Statement*, and the Governor's comments at the press conference. The RBNZ's interest rate forecast will reinforce these messages, most likely predicting that 90-day interest rates will remain unchanged until the second half of 2015, and rising slowly thereafter. The 90-day interest rate forecast could be around 30bp lower than the forecast the RBNZ issued back in September.

Financial markets would be broadly unsurprised by a *Monetary Policy Statement* along these lines. However, confirmation that the OCR is to remain on hold for some time might cause swap rates to drop slightly on the day. And rhetoric targeting the high exchange rate could well prompt a knee-jerk drop in the exchange rate on the day.

Inflation missing in action

The Reserve Bank hiked the OCR by a total of one percentage point in early- and mid-2014, only to be caught out by surprisingly low inflation later in the year. In response to low inflation, the September *MPS* heralded the beginning of a period of "monitoring and assessment" of inflation, during which the RBNZ would keep the OCR at its current level. The accompanying 90-day interest rate forecast seemed to indicate that the "monitoring and assessment" period would end in early-2015, although the RBNZ was at pains to emphasise that the timing would depend on how inflation evolved.

A few weeks after the September *MPS*, Statistics New Zealand revealed that inflation had dropped to just 1.0%. This was much lower than the RBNZ had forecast, and is the bottom of the vallowable inflation range under the RBNZ's Policy Targets Agreement.

Shortly after that inflation shock the RBNZ issued a further downgrade to the OCR outlook, in the October OCR Review. That one-page Review contained no reference to "policy tightening", instead saying only that "A period of assessment remains appropriate before considering further policy adjustment." We took this to mean that the hiking bias has been weakened but not eliminated, and that the Reserve Bank would hike the OCR again only once inflation was clearly rising.

However, the October Review consisted of only a few short paragraphs, leaving the subtleties open to interpretation. Some financial market participants (generally outside of New Zealand) took a more radical interpretation of the October OCR Review, and questioned whether the RBNZ intends to hike the OCR any further at all. We think that interpretation was incorrect – and subsequent RBNZ comments have backed our view. In its November *Financial Stability Review*, the RBNZ issued a pointed reminder that "further increases in short-term interest rates may be required in coming years."

The December *Monetary Policy Statement* should clear up any remaining doubt about what the RBNZ intends. This clarification need not take the form of pointed changes to the "bottom line" policy paragraph that usually appears on the first page of RBNZ monetary policy pronouncements. More likely, the December policy paragraph will repeat key elements from the October policy paragraph, including "period of assessment" (meaning the OCR is on hold for now), and "further policy adjustment" (indicating an expectation that the OCR will eventually rise, without being specific about timing).

The RBNZ's thinking will be clarified naturally via the 30-page *Monetary Policy Statement* and via the published interest rates. As already mentioned, we expect the interest rate forecast will be lower than the one issued in September, but will show rising interest rates nonetheless.

The ever-present question of house prices

The detail of the *Monetary Policy Statement* will discuss the outlook for the economy and inflation, including recent developments. One interesting topic will be the RBNZ's take on booming net immigration, falling mortgage rates, and the effect on house prices. The housing market was fairly slow until October, when the data registered quite a resurgence. In our view, the October data represents the start of a decent market upturn that had been delayed by September's election. However, the central bank is unlikely to alter its more sanguine view on the back of a single month's data. We expect that the RBNZ will retain the central view that house prices will remain well-behaved, but will discuss the risk of prices escalating more rapidly.

The main emphasis of the *MPS* will, of course, be inflation – why it has been so low, what the RBNZ is forecasting for the future, and what the response to surprising developments might be. The conclusion will almost certainly be that the RBNZ will leave the OCR unchanged until inflation actually moves up (as opposed to hiking the OCR in anticipation of rising inflation).

RBNZ to keep beating the exchange rate drum

The Reserve Bank has described the high exchange rate as "unjustified and unsustainable" at every OCR Review or *Monetary Policy Statement* since July. These are code-words for possible currency intervention – and the records now show that the RBNZ did indeed intervene in foreign exchange markets by selling New Zealand dollars in August this year. The Governor used "unjustified and unsustainable" again in a speech this week – failing to use them again next week would send the wrong signal. The impact of these words on currency markets does seem to diminish with the frequency of their use, but we are not yet at the point of zero impact. There remains a risk that the exchange rate will fall in the moments after the *MPS* is published.

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