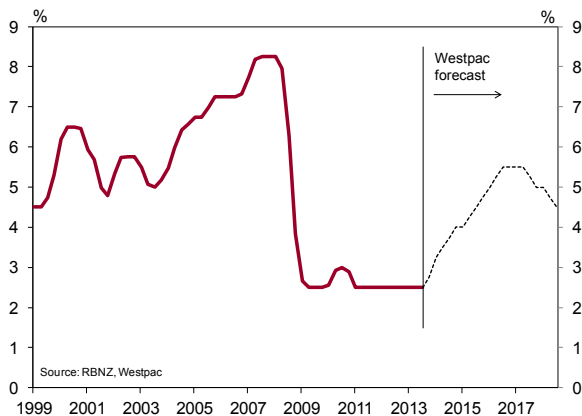


# Steady hand

## RBNZ OCR Review, January 2014

- The RBNZ left the OCR on hold at 2.5%, and gave a clear signal that the OCR is likely to rise in March.
- This decision was tactical. March offers a superior opportunity to communicate and justify a hiking decision.
- The Governor's speech tomorrow may also be used as an opportunity to explain what the RBNZ intends for the OCR this year.
- We continue to forecast five OCR hikes over the course of 2014, starting in March.

Westpac OCR forecast



The RBNZ left the OCR on hold today, but sent the clearest possible signal that it intends to hike the OCR in March. The key comment was:

*“...inflationary pressures are expected to increase over the next two years. In this environment, there is a need to return interest rates to more-normal levels. The bank expects to start this adjustment soon.”*

This was precisely what we and most other economists expected the RBNZ to do. It was also, in our opinion, the wisest course of action.

It is now abundantly clear that the economy warrants a higher OCR. As the RBNZ said in today's press release, *“New Zealand's economic expansion has considerable momentum”*, and inflation is rising.

But to deliver a hike today without prior warning and without much accompanying explanation might have appeared panicky and high-handed. Markets might have pushed the exchange rate and interest rates higher than the RBNZ intends.

The better option for the central bank was to wait six weeks until March, when it can deliver an OCR hike backed by a *Monetary Policy Statement* and a full set of economic projections. A hike in March is also anticipated by financial markets, and will therefore cause less market volatility.

The RBNZ has been emphasising the importance of clear communication as an aid to effective policymaking. Today's decision is entirely consistent with that emphasis.

In the same vein, we will be watching closely the speech the Governor is due to give in Christchurch tomorrow. This will be a great opportunity for the Governor to add colour around what the RBNZ expects to do with the OCR this year, including outlining the risks and contingencies.

## A clear case for hikes

As anticipated, the body of today's press release gave the impression that the RBNZ is now considering a more aggressive hiking cycle than it signalled six weeks ago in the December *MPS*. Extremely bullish words were chosen to describe the current state of and outlook for economic activity in New Zealand. The RBNZ is now forecasting around 3.5% GDP growth for 2014 compared to the forecast of 2.9% published in the December *MPS*.

Importantly, the RBNZ also sounds more concerned about inflation pressures. We took particular note of the comment: *"Construction costs are increasing and risk feeding through to broader costs in the economy."* In the past, the RBNZ has sounded more sanguine about the risk of the construction boom feeding through to inflation.

But the press release wasn't all bullish. The RBNZ acknowledged that there has been some moderation in the housing market. We agree with that assessment, and we would add that we anticipate further moderation ahead. However, the RBNZ factored a housing market slowdown into its thinking when it introduced the high-LVR mortgage restrictions. We suspect that the actual housing market slowdown has, so far, been no steeper than the RBNZ anticipated.

Similarly, the RBNZ described global growth as *"improving"*, but did note that the uncertain pace of US monetary tightening and the effect on emerging markets was a risk.

Comment on the high exchange rate was light, and focussed on the effect that the exchange rate is having on inflation: *"The high exchange rate continues to dampen inflation in the traded goods sector, but the Bank does not believe the current level of the exchange rate is sustainable in the long run."* In other words, the exchange rate is suppressing inflation for now, but it probably won't continue doing so for much longer, so OCR hikes will be needed instead. We concur with that assessment.

## Market implications

This OCR Review portrays a central bank that is calmly preparing for a steady but extensive series of OCR hikes. Yes, it does seem that the total size of the hiking cycle will be slightly larger than previously signalled. But there were no signs of panic in this press release.

Financial markets went into the statement pricing roughly a 30% risk of a hike today. With that risk removed, interest rates and the exchange rate had to fall. The two-year swap rate fell from 3.84% to 3.78%, and the NZD/USD exchange rate fell from 0.8263 pre-meeting to 0.8182 in the wake of the decision.

With such a steady hand on the monetary tiller, markets are now able to rule out some of the wilder RBNZ scenarios that had been floated. For example, it now strikes us as quite unlikely that the RBNZ will hike the OCR by more than 25 basis points in March. Markets are now pricing 111 basis points worth of OCR hikes over 2014 – we roughly concur with that assessment.

## RBNZ Press Release

OCR unchanged at 2.5 percent

Statement issued by Reserve Bank Governor Graeme Wheeler:

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

New Zealand's economic expansion has considerable momentum. Prices for New Zealand's export commodities remain very high, especially for dairy products. Consumer and business confidence are strong and the rapid rise in net inward migration over the past year has added to consumption and housing demand. Construction activity is being lifted by the Canterbury rebuild and by work in Auckland to address the housing shortage. Continued fiscal consolidation will partly offset the strength in demand. GDP grew by 3.5 percent in the year to September, and growth is expected to continue around this rate over the coming year.

While agricultural export prices are expected to come off their peak levels, overall export demand should benefit from improving growth in the global economy. However, improvements in the major economies have required exceptional monetary accommodation and there remains uncertainty about the timing of withdrawal of this stimulus and its effects, especially on emerging market economies.

Annual CPI inflation was 1.6 percent in 2013, and forward-looking measures of firms' pricing intentions have been rising. Construction costs are increasing and risk feeding through to broader costs in the economy. At the same time, there appears to have been some moderation in the housing market in recent months. The high exchange rate continues to dampen inflation in the traded goods sector, but the Bank does not believe the current level of the exchange rate is sustainable in the long run.

While headline inflation has been moderate, inflationary pressures are expected to increase over the next two years. In this environment, there is a need to return interest rates to more-normal levels. The Bank expects to start this adjustment soon.

The Bank remains committed to increasing the OCR as needed to keep future average inflation near the 2 percent target midpoint. The scale and speed of the rise in the OCR will depend on future economic indicators.

**Dominick Stephens**  
Chief Economist

## Westpac economics team contact details

**Dominick Stephens**, Chief Economist  
+64 9 336 5671

**Michael Gordon**, Senior Economist  
+64 9 336 5670

**Felix Delbrück**, Senior Economist  
+64 9 336 5668

**Anne Boniface**, Senior Economist  
+64 9 336 5669

Any questions email:  
economics@westpac.co.nz

For email address changes contact:  
WNZResearch@westpac.co.nz

## Disclaimer

**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.

**Disclaimer continued overleaf.**

## Disclaimer continued

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. 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.