

It's all part of the plan

November 2016 MPS Review: RBNZ cuts OCR to 1.75%, shifts to more neutral stance

- The Reserve Bank reduced the Official Cash Rate by 25bps to a record low of 1.75%, and shifted to a more neutral stance.
- Further cuts have not completely been ruled out, especially given the continuing uncertainty around the global environment and lingering softness in inflation. However, developments over the past few months have been positive for the New Zealand economy, and the downside risks to the RBNZ's view have diminished.
- We expect that the OCR will remain on hold for an extended period. However, longer term rates look set to rise from here.

A record low

At today's *Monetary Policy Statement*, the Reserve Bank cut the Official Cash Rate by 25bps, taking it to a new record low of 1.75%. And it looks like it will remain there for some time. The RBNZ noted that "current projections and assumptions indicate that policy settings, including today's easing, will see growth strong enough to have inflation settle near the middle of the target range". That marks a shift to a much more neutral stance by the RBNZ, after the last few months when they had strongly signalled that "further policy easing will be required".

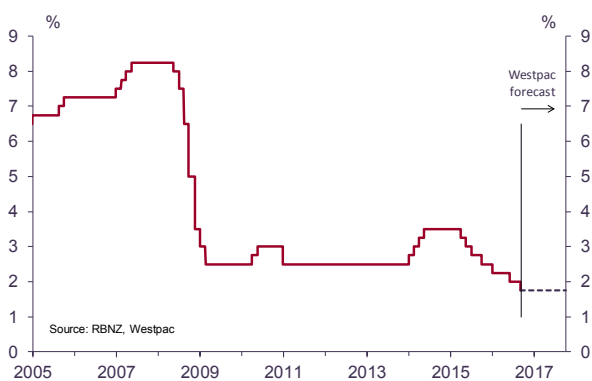
This doesn't mean that the door is completely closed with regards to further cuts. The RBNZ noted that "numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly" – a comment that implicitly acknowledges the uncertainty around the global outlook following the unexpected result of the US election. Reflecting such uncertainties, the RBNZ's projections show the OCR at 1.7%. The RBNZ only publishes OCR forecasts to one decimal place, but this suggests that they still see some small possibility of a further easing. However, it doesn't indicate any strong commitment to doing so. (Note: this is the first time the RBNZ has published an explicit forecast for the OCR, giving us a clearer view of their thinking on policy, unobscured by changes in funding spreads).

With economic activity humming along, we expect the OCR to remain on hold at the current level for an extended period. Inflation is expected to rise as some temporary factors drop out and as the economy strengthens. But the return to the target midpoint is still likely to be very slow, and the risk of overshooting is low.

It's all part of the plan

Today's cut comes in the face of signs that the New Zealand economy is on increasingly solid footing, with positive signs in the household and business sectors, continued strong population growth, and gains in commodity prices. Against this positive backdrop, there was some question about whether a cut was even needed today.

Westpac OCR forecast



However, the strength in activity that we're seeing is at least in part due to the current record low levels of interest rates. The RBNZ needs the economy to continue running at a solid pace to generate a pick-up in domestic pricing pressures in the face of continued softness in global inflation.

In addition, today's decision was very well signalled in recent policy statements and a recent speech, and market pricing had adjusted accordingly. Failure to deliver would have risked sharp moves higher in both the New Zealand dollar and wholesale interest rates – effectively resulting in an unwanted tightening of monetary conditions.

Slow and steady wins the race

To ensure the economy continues trucking along, the OCR will need to remain low for some time. However, the downside risks to the domestic economic outlook have been dissipating. Furthermore, the RBNZ remains conscious of the risks of over-stimulating the economy and housing market, as well as the associated risks for the exchange rate. Consequently, rather than cutting the OCR further over the coming year to spur a rapid increase in prices, they can take their foot off the accelerator for the time being.

Consistent with this, the RBNZ is targeting a gradual return of inflation to the 2% midpoint of the target band. The RBNZ's updated forecasts have inflation returning to 2% in Q4 of 2018 (just slightly later than their previous forecast).

This gradualism also reflects that much of the softness in inflation that we're seeing is due to offshore factors, including softness in global trade and inflation. These factors are continuing to weigh on import prices in New Zealand, and are beyond the control of domestic monetary policy. That's a judgement that seems very appropriate to us.

The RBNZ's forecasts show a degree of caution around some of the positive factors boosting economic activity. In the case of dairy prices, the RBNZ noted the risk that some of the strong gains in recent months could reverse. And in the case of the household sector, the RBNZ noted that the boosts from migration and house prices are expected to have a more muted impact on consumption than in the past.

One of the key concerns for the RBNZ continues to be inflation expectations. While the decline seen in recent years has been arrested, shorter-term expectations remain lower than desired. In addition, with inflation low, there is still some risk that expectations decline further. That would be a major concern for the RBNZ, affecting wage a price setting decisions, and potentially eroding the effectiveness of interest rate reductions. This will be an area that the RBNZ continues to monitor closely.

The other key concern that will be keeping the RBNZ's staff up at night is the health of the global economy. Global demand remains subdued, and the related softness in global

inflation has had a large impact on the RBNZ's thinking. On top of this, the risk of volatility in global financial conditions remains omnipresent, with events such as the ongoing Brexit negotiations and last night's unexpected US election result adding a further layer of uncertainty. Although such concerns have been trumped by the strength of domestic activity in recent months, the RBNZ will no doubt be keeping an eye on developments offshore over the coming months.

Where to from here?

Our stance has been that after today's cut the OCR would be on hold for an extended period. Financial markets and other forecasters have been coming around to that view in recent weeks, and the RBNZ is now also signalling, barring future shocks, 1.75% is most likely to mark the low point for the OCR.

However, that doesn't mean we'll see the same stability in the interest rates faced by borrowers and savers. Term interest rates are facing upward pressure from several sources. First, global interest rates have already been trending higher in recent weeks, with New Zealand carried along for the ride. And after an initial panic move lower, the market's verdict now seems to be that a Trump presidency will mean higher long-term borrowing rates.

Second, banks are facing a higher mix of funding costs relative to the level of the OCR. Until recently, growth in deposits had broadly matched lending growth. But in recent months, there has been a marked shortfall in deposit growth, which may be a sign that people are seeking out higher-return investments. The gap can be filled with wholesale funding, but this is both costly and increasingly constrained by regulatory requirements. So we may see lending and deposit rates creep higher independently of the OCR.

Finally, in the near term at least, there's a risk that the market goes overboard in trying to anticipate the timing of OCR hikes. Interest rate markets are already factoring in more than a 50% chance of a 25bp hike by the end of 2017. That seems far too early to us. The RBNZ is still likely to be looking at inflation in the lower half of its target range by that point; the risk of overshooting the target seems low.

If the above points hold true, the RBNZ will be facing an implicit tightening of monetary conditions over the next couple of years anyway. We don't think that the RBNZ would go as far as cutting the OCR further to try to offset this trend. But we wouldn't be surprised if future RBNZ statements move away from signalling a bias for future OCR moves, and place more emphasis on the "monetary policy will continue to be accommodative" clause.

Michael Gordon

Acting Chief Economist

Satish Ranchhod

Senior Economist

RBNZ Statement

The Reserve Bank today reduced the Official Cash Rate (OCR) by 25 basis points to 1.75 percent.

Significant surplus capacity exists across the global economy despite improved economic indicators in some countries.

Global inflation remains weak even though commodity prices have come off their lows. Political uncertainty remains heightened and market volatility is elevated.

Weak global conditions and low interest rates relative to New Zealand are keeping upward pressure on the New Zealand dollar exchange rate. The exchange rate remains higher than is sustainable for balanced economic growth and, together with low global inflation, continues to generate negative inflation in the tradables sector. A decline in the exchange rate is needed.

Domestic growth is being supported by strong population growth, construction activity, tourism, and accommodative monetary policy. Recent dairy auctions have been positive, but uncertainty remains around future outcomes. High net immigration is supporting growth in labour supply and limiting wage pressure.

House price inflation remains excessive and is posing concerns for financial stability. Although house price inflation has moderated in Auckland, it is uncertain whether this will be sustained given the continuing imbalance between supply and demand.

Headline inflation continues to be held below the target range by ongoing negative tradables inflation. Annual CPI inflation was weak in the September quarter, in part due to lower fuel prices and cuts in ACC levies. Annual inflation is expected to rise from the December quarter, reflecting the policy stimulus to date, the strength of the domestic economy, and reduced drag from tradables inflation.

Monetary policy will continue to be accommodative. Our current projections and assumptions indicate that policy settings, including today's easing, will see growth strong enough to have inflation settle near the middle of the target range. Numerous uncertainties remain, particularly in respect of the international outlook, and policy may need to adjust accordingly.

Contact the Westpac economics team

Michael Gordon, Acting Chief Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Anne Boniface, Senior Economist +64 9 336 5669

David Norman, Industry Economist +64 9 336 5656

Sarah Drought, Economist +64 9 336 5696

Any questions email: economics@westpac.co.nz

Disclaimer

Things you should know

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141 ('Westpac'). This information is correct at 1 July 2016.

Disclaimer

This material contains general commentary, research, and market colour. The material does not constitute investment advice. The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner. 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 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 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. 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.

Country disclosures

Australia: Westpac holds an Australian Financial Services Licence (No. 233714). This material is provided to you solely for your own use and in your capacity as a wholesale client of Westpac.

New Zealand: In New Zealand, Westpac Institutional Bank refers to the brand under which products and services are provided by either Westpac or Westpac New Zealand Limited ("WNZL"). Any product

or service made available by WNZL does not represent an offer from Westpac or any of its subsidiaries (other than WNZL). Neither Westpac nor its other subsidiaries guarantee or otherwise support the performance of WNZL in respect of any such product. The current disclosure statements for the New Zealand branch of Westpac and WNZL can be obtained at the internet address www.westpac.co.nz. 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: This material has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (as defined in the applicable Singapore laws and regulations) only. Recipients in Singapore of this material should contact Westpac Singapore Branch in respect of any matters arising from, or in connection with, this material. 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 licence 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 activities. This material is intended only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance. 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.

UK: The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. 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.

Disclaimer continued

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication 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 communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation (EU) 596/2014).

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.

Investment Recommendations Disclosure

Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts of interests associated with the provision of investment recommendations.

- (i) Chinese Wall/Cell arrangements;
- (ii) physical separation of various Business/Support Units;
- (iii) Strict and well defined wall/cell crossing procedures;
- (iv) a "need to know" policy;
- (v) documented and well defined procedures for dealing with conflicts of interest;
- (vi) reasonable steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.