

A certain point of view

March MPS Preview: OCR still on hold until mid-year

- We expect the March *Monetary Policy Statement* to maintain a similar tone to recent RBNZ statements, with rate hikes likely to begin around mid-year.
- Recent instances of softer than expected data are unlikely to sway the RBNZ as much as they have swayed the market.

Comment

Next Thursday's *Monetary Policy Statement* is likely to maintain the tone of recent statements. The global recovery continues, though with some countries facing financial sector strains and still reliant on policy support; New Zealand is benefiting from policy stimulus, strong export earnings and more confident consumers; the RBNZ is on track to start increasing the OCR from around mid-year, and will continue to bring policy settings back to 'normal' over the next couple of years.

This may come as a surprise to the market, which has taken some of the softer data in recent weeks – such as unemployment, retail spending and house sales – as a reason to push out the expected timing of the first rate hike, and seems to be expecting the RBNZ to do the same. The trick is that it depends on what you use as your point of comparison. Relative to the January OCR view, we may see more emphasis on the uncertainties around the global recovery that have emerged in recent weeks. But compared to the last set of forecasts published in December, the evidence has if anything been in favour of higher interest rates.

Looking at how the RBNZ will have viewed the recent data:

Growth: The overall global picture has improved since December. The 2009 outturns for the US, Australia and China were stronger than expected, and forecasts for 2010 global growth have been shaded up further. In New Zealand, September quarter GDP grew 0.2%, a little weaker than the RBNZ's forecast of 0.4%, but it's likely that there was a negative impact from swine flu that will be reversed later. Indicators for the December quarter point to something substantially stronger than the RBNZ's pick of 0.6% – we are currently forecasting a 1.1% gain.

Inflation: The CPI fell by 0.2% in Q4, a downside surprise to the market but not to the RBNZ. And the near-term inflation picture is not as benign as the RBNZ hoped: higher food prices, higher fuel prices, rising car prices, tertiary fee increases, higher pricing intentions, and the weaker exchange rate all point to Q1 inflation of around 0.9%, compared to the RBNZ's forecast of 0.1%. Looking a bit further ahead, now that the Emissions Trading Scheme is official policy, the RBNZ will have to incorporate the temporary impact on inflation. Even further ahead, inflation expectations remain stubbornly high, with the latest survey finding that businesses expect annual inflation to reach 2.7% in two years' time.

Employment: The Q4 unemployment rate of 7.3% was a shocker, though the RBNZ will probably still regard it as being close to or at the peak. On the other hand, capacity utilisation has rebounded rapidly, and is back to above-average levels. So the overall signals on resource pressures are mixed.

Consumption: Retail sales volumes rose 1% in the December quarter (and 1.3% ex-auto, which correlates more closely with the consumption part of GDP). That was the strongest quarter since March 2007, and indicates that spending growth has been accelerating over the last three quarters. The market treated this as 'bad' news only because it was expecting something even stronger!

The consumer outlook will be one of the biggest headaches for the RBNZ right now. Their December forecasts were based on the assumption that households will be more cautious during the recovery, and would be less responsive than usual to the recovery in house prices, using it as an opportunity to reduce debt instead. That clearly hasn't happened: household spending is on the rise again, and their rediscovered housing wealth will surely have played a part in this.

On the other hand, if consumers are responding to house values, the recent proposals aimed at the housing market could do more of the work for the RBNZ than they expected. The government is considering a range of measures aimed at property investment, and although new taxes specifically

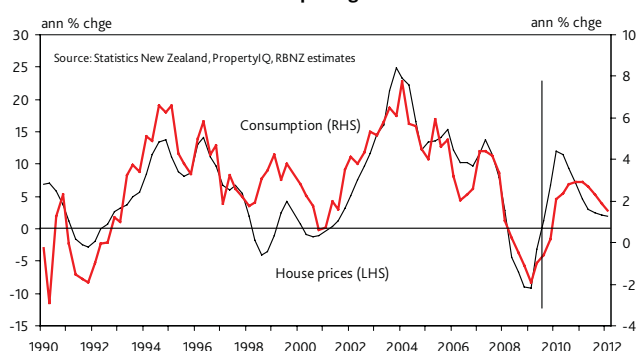
For further information, questions or comments contact Brendan O'Donovan, telephone (04) 470 8250, email bdonovan@westpac.co.nz

For all clients: Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141, incorporated in Australia ("Westpac"). The information contained in this report: does not constitute an offer, or a solicitation of an offer, to subscribe for or purchase any securities or other financial instrument; does not constitute an offer, inducement or solicitation to enter a legally binding contract; and is not to be construed as an indication or prediction of future results. The information is general and preliminary information only and while Westpac has made every effort to ensure that information is free from error, Westpac does not warrant the accuracy, adequacy or completeness of the Information. The Information may contain material provided directly by third parties and while such material is published with necessary permission, Westpac accepts no responsibility for the accuracy or completeness of any such material. In preparing the Information, Westpac has not taken into consideration the financial situation, investment objectives or particular needs of any particular investor and recommends that investors seek independent advice before acting on the Information. 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. Except where contrary to law, Westpac intends by this notice to exclude liability for the information. The information is subject to change without notice. Westpac expressly prohibits you from passing on this document to any third party. Westpac Banking Corporation is registered in England as a branch (branch number BR000106) and is authorised and regulated by The Financial Services Authority. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised and regulated by The Financial Services Authority. © 2010 For Australian clients: WARNING – This document is provided to you solely for your own use and in your capacity as a wholesale client of Westpac.

for housing have been ruled out, there is still plenty on the table that could affect house values: removing depreciation allowances, ring-fencing losses on rental properties, and – potentially the most potent of all – reducing the tax shield for investors by cutting the top income tax rate.

Concerns about these potential changes have already had an impact: house sales have slowed sharply since the proposals were made in December, and the RBNZ's (and our) previous forecast of double-digit house price growth now looks unlikely. Still, the net effect is that the gap between house prices and consumption that the RBNZ projected in December (as in Figure 1) will need to be closed up from both directions.

Figure 1: Real house price inflation and private consumption growth



NZ dollar: The trade-weighted index is 2.5% lower than the RBNZ's December projections. But as we argued last year, when the NZD was heading up, what matters is not just the movement in the currency but the reasons behind it. In recent weeks the NZD has been weighed down by market concerns about Greece's government debt woes, with the potential for contagion into other parts of Europe and then into wider emerging markets. If the situation deteriorates then a weaker NZD is warranted; if the Greece situation is resolved then the NZD may head higher again.

Putting it all together, despite weak spots in some of the recent data, the RBNZ is likely to conclude that the recovery is proceeding on track with their December MPS forecasts. If anything, the evidence of stubborn inflation pressures may warrant a small upward revision to their 90-day rate projections. If so, it's unlikely to come through as a shift in the expected timing of the first hike – since "the middle of 2010" is only around three months, or two review dates, away – but there may be a steeper profile of rate hikes for the first year or so.

Brendan O'Donovan, Chief Economist, Ph: (64-4) 470 8250

Michael Gordon, Markets Economist, Ph: (64-4) 381 1412