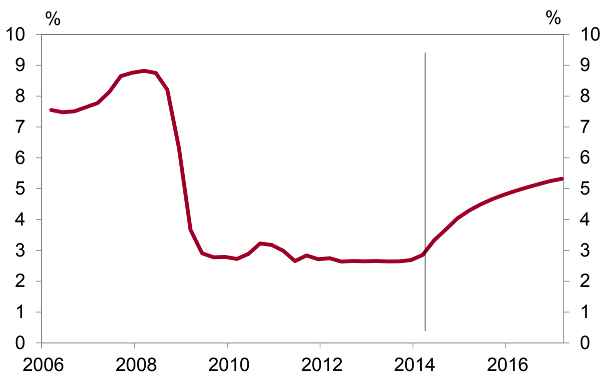
![Westpac Institutional Bank]

17 April 2014

Easter, but no surprise

- We expect the Reserve Bank will increase the OCR to 3% when it reviews the OCR on Thursday 24th April.
- The accompanying press release will reiterate that inflation pressures are building and so the OCR needs to rise.
- However, we expect that this OCR Review will strike a more cautious tone than the March MPS, due to soft inflation data and the high exchange rate.
- The RBNZ is probably still on track to hike the OCR again in June, but question marks are starting to appear around the July hike that we had pencilled in.

RBNZ 90-day interest rate forecast, March MPS



In its communications earlier this year, the Reserve Bank made it crystal clear that it expects to increase the OCR by approximately two percentage points over two years. And the 90-day interest rate forecast in the March 2014 *Monetary Policy Statement* seemed to indicate that the RBNZ was planning four OCR hikes in a row, in March, April, June and July.

Of course, the RBNZ always emphasises that its interest rate forecasts are conditional on the economy evolving in line with expectations. What RBNZ-watchers like us need to figure out is whether recent data has matched the RBNZ's expectations– if so, then we can assume they are still on track for four hikes in a row. If not, then we must figure out how the RBNZ will alter its plan.

The balance of developments over the past few weeks has pointed in the direction of less inflation pressure. The trade-weighted exchange rate has risen 2.5% higher than the RBNZ forecast, at the same time as dairy prices have dropped sharply. And inflation has been below the RBNZ's forecast, although that probably represents food price volatility rather than a new trend. True, net migration has been stronger than the RBNZ forecast, but that is only a partial offset.

The RBNZ will probably acknowledge these developments in the press release accompanying the April OCR Review next week. And it will probably add cautious-sounding words into its summary of the inflation and interest rate outlooks, which in March was:

"While headline inflation has been moderate, inflation pressures are increasing and are expected to continue doing so over the next two years... it is necessary to raise interest rates towards a level at which they are no longer adding to demand."

But the extent of the downside developments does need to be kept in perspective. If five weeks ago the RBNZ was thinking about pushing the OCR up by 200 basis points (bp) over two years, then they are probably now considering a number more like 175bp.

That is not nearly enough of a change to kibosh the April hike - we still expect the RBNZ will lift the OCR to 3% next week, as markets expect.

Importantly, the degree of downside surprise has not been enough for the RBNZ to signal an explicit change of plan. The main messages of the press release will probably be the same as the March *MPS* – the economy is gathering momentum, construction is booming, inflation pressures are building, and therefore the OCR needs to rise. If we are correct, and that is still the main message, then we can be reasonably assured that the RBNZ still expects to hike the OCR in June – again, as we and the markets currently expect.

What is becoming more doubtful in our minds is the prospect of a July hike. Should the exchange rate remain high or the data weaken, then June would be the natural opportunity for the RBNZ to deliver a final hike and signal a pause in the cycle. In June, unlike next week, the RBNZ will have the luxury of a full *Monetary Policy Statement* to explain its new expectation for the pace of interest rate hikes, thereby avoiding any overreaction from financial markets.

However, the question of a July hike is not one we will get any clarity on next week.

Market implications

A 25 basis point hike accompanied by a press release along the lines we anticipate, acknowledging the high exchange rate and weak inflation data but nevertheless indicating that the OCR needs to go up, would elicit no reaction from financial markets.

By contrast, an on hold decision or an explicit signal that the pace of hikes is likely to be slower than previously signalled would produce a large drop in the swap rates and the exchange rate.

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