bnz capital

11 June 2009

# RBNZ Takes Bold Step Toward Middle Ground

- RBNZ keeps OCR at 2.50%, until 2010H2
- While switching focus to recovery, from risks
- NZ rates, TWI, react accordingly – upwards
- Reinforcing broader risks of GDP hiccups, in our view
- MPS assumed TWI drop defies its turning point opinion
- Nonetheless, we'll now adopt a 2.50% OCR base case

Today's Monetary Policy Statement (MPS), while difficult to poke holes in, was quite some shift from the dovish undertones of the late-April OCR review, and the risk-riddled Financial Stability Report (FSR) of four weeks ago. Its unchanged cash rate, of 2.50%, was no genuine affront to our rate cut view. This decision was always touch and go. The big deal is that the Reserve Bank has taken a big step toward the middle ground, as it begins to put more weight on the recovery, rather than risks. The question is; is it too bold a step, too soon?

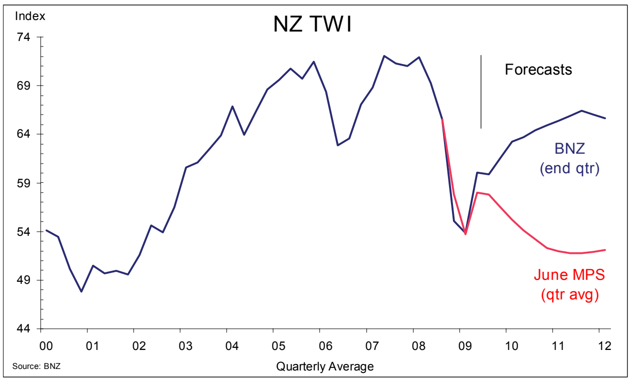
Unfortunately, we won't get a clear answer to that until much later this year, rather than being something we can expect closure on over the next month or two. The RBNZ has certainly made its intentions clear, in signalling an on-hold path for the foreseeable future. Granted, the Bank's front-page text still made noises that "the OCR could still move modestly lower over coming quarters", as it did in April. However, the MPS document, in its entirety, suggested this was now not much more than a lip-service bias.

The thrust of the Bank's commentary was more in keeping with its 90-day bank bill forecasts, which flat-lined at 2.80% in yield. This flatly denied the further easing we thought this MPS might have projected for the near term, especially if Bollard held firm today. Yes, it was helpful that the Bank's projections implied the OCR staying at a 2.50% low right the way into the second half of next year.

But that might get lost in the wash, with greater global forces now bearing upwards on mid to long NZ wholesale interest rates.

Part of this, of course, relates to the huge demand governments around the world are now placing on the world's capital, as they struggle to fund the massive fiscal deficits that are so important for averting a deeper global recession and deflation.

In this respect, we suspect the Bank has misjudged the impact today's MPS will have on the markets. It's not as though its messages were unreasonable. But monetary




policy never works in a vacuum. The Bank looked to be heeding this back in March, when its emphasis on slowing down the easing cycle was important in stopping the markets galloping too far down easy street. But today's MPS would seem to have dropped the ball, in that it risks egging on the recovery-trade movements in NZ rates and the currency that were bound to happen to some extent anyway.

We need only look at today's market reaction to get an inkling of this. Key wholesale rates have jumped by more than was consistent with removing the slight chances attributed to a 25bp rate cut today. The 1-year swap rate has increased 10bps, but the 2-year is up about 20bps in yield. These will put upward pressure on retail interest rates, at a time when assessing appropriate margins remains as complex as it's been for ages.

But our broader concern is with the currency. It has already reacted "favourably" to the on-hold-with-recovery-on-top story the June MPS emphasised. Kiwi has put on more than half a cent, as has NZD/AUD.

Did the RBNZ really think its projected fall in the TWI would dominate the market's attention, when its big story was about a probable turning point? Then why has the June MPS assumed the TWI, while holding up over the next month or two, will trend lower from here?

It says this is based on international investors becoming nervous about New Zealand's current account deficit. But the MPS forecasts this contracting to about 6% of GDP within a year, from its present 9% or so (much as we are). And surely the last six months have demonstrated that, try as they might, foreigners have struggled to conclude bad things about New Zealand's external accounts. Standard and Poor's has even removed its negative outlook on our sovereign debt rating.

TWI weakness, based on international concerns with our current account, thus seems inconsistent with the global recovery view the RBNZ is apparently signing up to.

And, no, the Bank is not likely to intervene to try to bring the TWI down in line with its signalled path. The criteria for doing so are not remotely being met. While Bollard will no doubt try to express his displeasure of TWI strength at every opportunity, the reality is he'll have to grin and bear its movements for the meanwhile.

In the end, the June MPS has effectively underwritten upside in the exchange rate and NZ yields. This reinforces the broader risks that any recovery we begin to witness simply runs out of puff before too much longer.

Even in respect of global growth, it seems premature to lock and load the recently improving trend-lines. While these are encouraging, and undeniable, they are hardly yet into positive territory and could just as easily turn out to be false dawns as much as genuine recoveries.

To be sure, the RBNZ, while acknowledging the bigger than anticipated hole the world economy has dug itself into this year, has a more sober view on the global GDP rebound for 2010 than does the current consensus. However, the big test will be whether the international data over the coming months better justify the global GDP expansion the consensus is implying for the second half of this year.

And while financial markets are on the mend in many respects, that's not to deny ongoing risks of something blowing up, somewhere, and of the general global de-leveraging process (remember that?) rearing its ugly head again at some stage. In this sense, the notion of a sustained international recovery from here might seem far too good to be true.

But it's not just the international news that will be interesting to keep tabs on. It was clear from today's MPS that the Bank is beginning to bring domestic indicators back on the table, in framing its assessments and conclusions.

In particular, it has taken note of the recent recovery in house sales and some of the broader household sector indicators that have come back from the death. It was only four weeks ago, at the FSR, when RBNZ officials restated the April-review opinion of the housing market still firmly biased to the downside (something the NZ Treasury also espoused in the late-May Budget). Now, it seems, the Bank is suddenly wondering about house prices increasing again, as unfounded as it believes this would be.

Underpinning the Bank's household sector discussion was frequent reference to the strengthening in net immigration that's occurring. This will thus be important to monitor – especially as the RBNZ would seem to be under-appreciating the extent to which it could pick up. While it has bolstered its net immigration view compared to the March MPS, it would seem not by much. And word is that it's principally based on a further fall-off in departures rather than any strong pick-up in migrant arrivals. We certainly expect a strong increase in inward migration this year, and next.

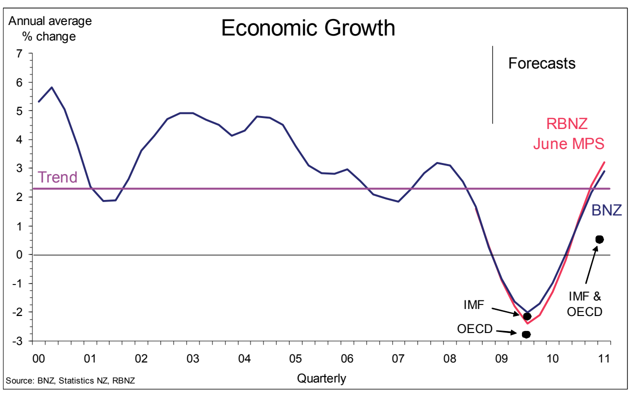
So, keep an eye on data for immigration, housing, consumer spending and confidence as emboldening the Bank's view of recovery.

In contrast, the June MPS seems to have downplayed the exposures of New Zealand's two biggest export industries. One is the dairy sector, which rated no more than a few sentences – even though it's likely to be one of the biggest drags on the economy over the next twelve months.

The other is tourism. While the Bank did mention a likely drop-off in services exports, that was about it. We thought the tourism industry deserved a full discussion, especially with risks of greater damage from the H1N1 virus – which is already having impacts, and could yet be a big deal for the NZ economy.

As for the Statement's broad macro-economic forecasts, they looked reasonable enough. The strong recovery of the March MPS has been scaled back. Falls in Q1 and Q2 GDP, of 1.0% and 0.3% respectively, yield to a moderate pick-up into 2010, with strong growth deferred to 2011. Note, though, that this is in the context of a lowered GDP speed limit for the next few years, of closer to 2.0% than the usually assumed 3.0% – a sensible view, in our opinion, even with strengthened immigration.

As for CPI inflation, the June MPS sees this continuing to dip in the near term but, helped by the declining TWI, creeping back up to the 2.0% mid-point of the target band beyond that. Also, the Bank made it clear it doesn't expect international inflation to get out of hand anytime soon – as some in the markets fear – but instead thinks it remains subdued before picking up a bit.

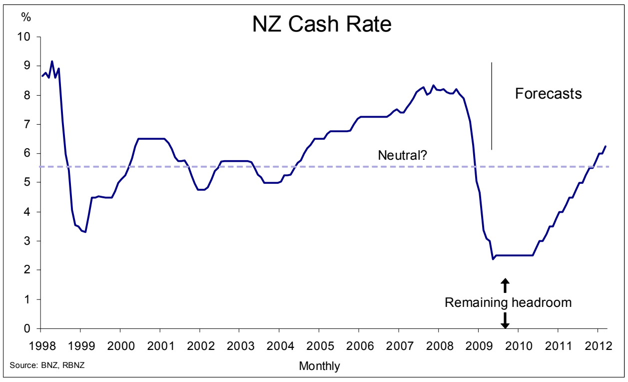


In general, we don't have a beef with the June Statement's broad macro-economic sketches. It's more the timing and (downside) risks we remain uncomfortable about.

This was further indicated with the Bank alternative scenario being mainly about a "delayed rebalancing" – something that raises concerns about external imbalances more than for the economy, overall.

For the meantime, however, we've decided to take the June MPS at its word and run with the 2.50% OCR base it projects into 2010. But that's not to completely abandon the downside risk to the cash rate we previously saw by the end of the year. We believe it's something to keep very firmly in mind, albeit now as a strong risk rather than something we have in our central track.

Even so, it will take time for any clear pressure for further OCR pruning to become obvious. So, we expect the Bank to retain its steady-as-she-goes outlook for the near term.




But we'll be watching intently for anything that might frustrate the Bank's presumed economic recovery story. This might be a stronger than justified currency. It might be a knock to the nascent global optimism. It might even be hiccups in the household sector bounce-back the Bank is taking note of. We'll see.

craig_ebert @bnz.co.nz

### The news release of today's RBNZ Monetary Policy Statement – OCR unchanged at 2.5 percent

The Official Cash Rate (OCR) will remain unchanged at 2.50 percent.

Reserve Bank Governor Alan Bollard said: "The economic outlook remains weak both in New Zealand and in other countries. However, there are signs that international economic activity is stabilising, and international financial conditions are improving. We expect the New Zealand economy to begin growing again toward the end of this year but the recovery is likely to be slow and fragile. Many key economic indicators such as unemployment are projected to keep deteriorating well into 2010.

"There remain some material downside risks to activity and inflation, but for the first time in some months we can also identify some clear upside opportunities for activity. One such area is a potential rebound in household spending and residential investment as a result of the rise in net immigration and the pick-up in the housing market. Ultimately, however, we do not think such a rebound in spending would prove sustainable given the soft outlook for employment, wages and farm incomes and high levels of household debt.

"On balance, the risks to activity remain weighted to the downside.

"The recent rise in the New Zealand dollar creates an unhelpful tension with our projections. A stronger dollar at a time of weak global growth risks delaying or even reversing the projected increase in exports, putting the sustainability of recovery at risk.

"Overall, recent developments point to lower inflationary pressure than previously projected. Annual CPI inflation is likely to fall temporarily below the bottom of the target band later this year, but we expect it to return to inside the band by early 2010 and remain comfortably there over the remainder of the projection.

"We have cut the OCR by a large amount over the year. We expect the effects to pass through to more borrowers over coming quarters as existing fixed-rate mortgages come up for re-pricing. Although rising longer-term interest rates overseas are placing upward pressure on longer-term lending rates here, there is room for further reductions in shorter-term lending rates.

"The low OCR and stimulatory fiscal policy are the main sources of support to the New Zealand economy at present. It is likely to be some time before the recovery becomes self-sustaining and monetary policy support can be withdrawn.

"We therefore consider it appropriate to continue to provide substantial monetary policy stimulus to the economy. The OCR could still move modestly lower over the coming quarters. As we said at the time of the April OCR decision, we expect to keep the OCR at or below the current level through until the latter part of 2010."

# Contact Details

## BNZ Capital


**Stephen Toplis**
Head of Research
+(64 4) 474 6905

**Craig Ebert**
Senior Economist
+(64 4) 474 6799

**Mark Walton**
Economist
+(64 4) 474 6923

**Danica Hampton**
Senior Strategist
+(64 4) 472 4767


## Main Offices

**Wellington**
1 Willis Street
PO Box 2392
Wellington 6140
New Zealand
Phone: +(64 4) 474 6145
FI: 0800 283 269
Fax: +(64 4) 474 6266

**Auckland**
125 Queen Street
PO Box 2139
Shortland Street
Auckland 1140
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

**Christchurch**
129 Hereford Street
PO Box 1461
Christchurch 8140
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

## National Australia Bank


**Peter Jolly**
Head of Research
+(61 2) 9295 1199

**Alan Oster**
Group Chief Economist
+(61 3) 8641 3464

**Rob Henderson**
Chief Economist, Markets
+(61 2) 9237 1836

**John Kyriakopoulos**
Currency Strategist
+(61 2) 9237 1903


## Contact Phone Numbers

**Wellington**

| | |
|---|---|
| Foreign Exchange | +800 642 222 |
| Fixed Income/Derivatives | +800 283 269 |

**Sydney**

| | |
|---|---|
| Foreign Exchange | +800 9295 1100 |
| Fixed Income/Derivatives | +(61 2) 9295 1166 |

**London**

| | |
|---|---|
| Foreign Exchange | +800 333 00 333 |
| Fixed Income/Derivatives | +(44 20) 7796 4761 |

**New York**

| | |
|---|---|
| Foreign Exchange | +1 800 125 602 |
| Fixed Income/Derivatives | +1877 377 5480 |

**Hong Kong**

| | |
|---|---|
| Foreign Exchange | +(85 2) 2526 5891 |
| Fixed Income/Derivatives | +(85 2) 2526 5891 |

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