ECONOMICS

5 Jun. 09

Economic Update

Hold and hope

Preview of June 11th Monetary Policy Statement

- **We expect the RBNZ to hold the OCR at 2.5% on June 11.**
- **Sentiment improved on green shoots and current market conditions may limit OCR impact.**
- **Downside risks remain & further stimulus likely, RBNZ may also need to use other tools.**

We expect the RBNZ will keep the Official Cash Rate (OCR) on hold at 2.5% next week. The RBNZ is very close to the end of its easing cycle: its reluctance to cut the OCR below 2.0% leaves only 50 basis points of potential rate cuts up its sleeve. Now is a good time to pause and assess the impact of monetary stimulus to date. The RBNZ is likely to be uncomfortable with current levels of the NZ dollar and longer-term fixed interest rates. However, current market forces are likely to limit the impact of an OCR cut at the minute: there may be better opportunities in the future. The risks to the RBNZ's inflation outlook remain to the downside and additional monetary stimulus is likely to be needed further down the track. The OCR remains the RBNZ's main tool of choice, but once the OCR is at 2% the RBNZ may have to consider alternative options.

We have canvassed a number of options available to the RBNZ. Many carry risks and some are likely to be ineffective. We don't rule out the RBNZ taking other actions at this meeting. However, the RBNZ is likely to remains reluctant to use them at this point, with thresholds for their use high. But the wildcard risk for the day is some action is taken to try and drive interest rates and the exchange rate lower.

RBNZ easing cycle close to the end

Easing cycle close to end

Since commencing the easing cycle in July 2008 the RBNZ has slashed 5.75 percentage points off the OCR, including the dramatic 150 basis point cuts in December and January. The OCR now sits at 2.5% – leaving the RBNZ with just 50 basis points worth of cuts up its sleeve (relative to its own perceived floor), so where to from here?

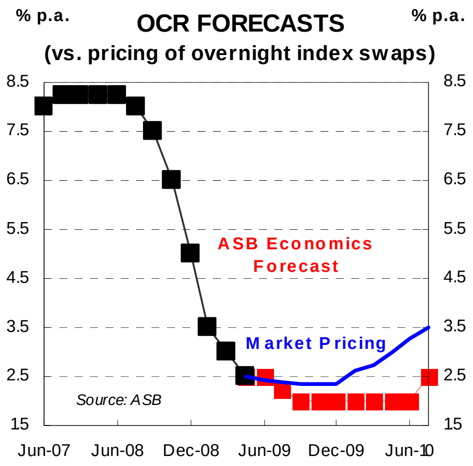
Green shoots and market confidence

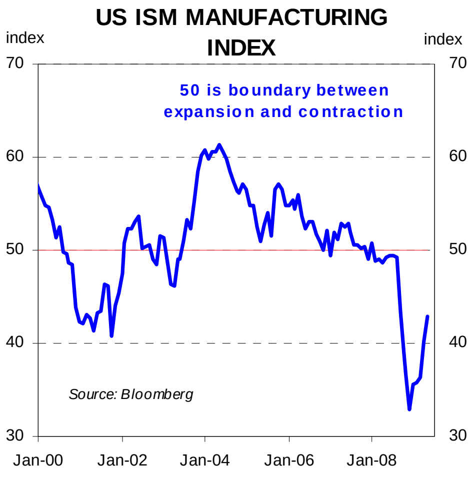
Market confidence improves on green shoots

Over the past three months markets have become fixated on so called 'green shoots'. That is, signs that the global economy is stabilising, and confirming the bottom of the recession is in sight. The initial excitement of a potential V-shaped recovery has since faded as subsequent data continued to 'bounce along the bottom' rather than show a sustained improvement. Nonetheless, with the end in sight and pace of decline slowing, sentiment has improved.

Economic indicators stabilise

In particular the US housing market appears to have stabilised. Although it is not yet recovering, the rate of decline appears to have slowed significantly. Likewise, industrial production (or indicators of) have picked up slightly, although are likely to remain at low levels for some time yet. In addition, the release of US Bank Stress Test results caused little upset to market confidence.





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Forecasts for world growth stabilise

With data starting to stabilise, so too have forecasts for NZ trading partner GDP. Revisions to monthly *Consensus* Forecasts have become much smaller and no longer present large surprises; trading partner GDP is expected to contract 2.3% over 2009 and recover 2.0% over 2010.

NZ economic developments mixed

NZ housing market recovers

At home there have also been some positive signs. The housing market recovered over March and April, albeit demand remains at below-average levels. Business confidence has recovered to around neutral levels, suggesting GDP will bottom out around the end of 2009. The rise in the unemployment rate has been slower than expected.

But also some disappointing data

However, the news hasn't all been positive. Retail trade volumes contracted a whopping 2.9% over Q1 – much worse than expected. Fonterra's forecast payout for 2009/10 season of $4.55 kg per milk solid disappointed the expectations of many. The NZ dollar has picked up off its lows, on the back of US dollar weakness, making an export-led recovery appear even more unlikely. Inflation pressures are abating rapidly, and incorporating the higher NZ dollar there remains significant downside risk to inflation. Finally, interest rates have also picked up off their lows, particularly at the longer end, as markets have become increasingly wary of the large supply of government debt set to flood global markets over the next few years.

NZ dollar and interest rates up off lows

Financial markets

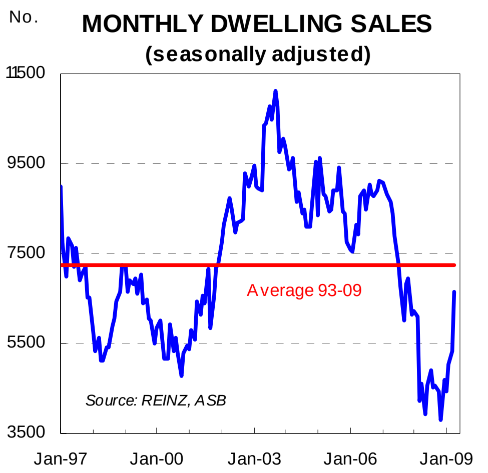
Tighter financial conditions may worry RBNZ

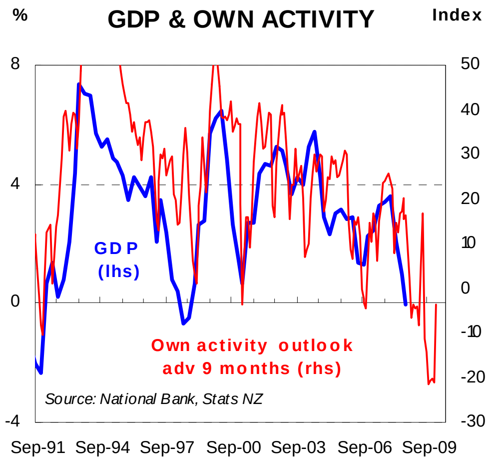
The RBNZ is unlikely to be comfortable with where the currency and longer-term interest rates are currently sitting, and normally we would argue for the RBNZ to cut the OCR to help reduce the upward pressure in these markets (indeed this was our argument back in April).

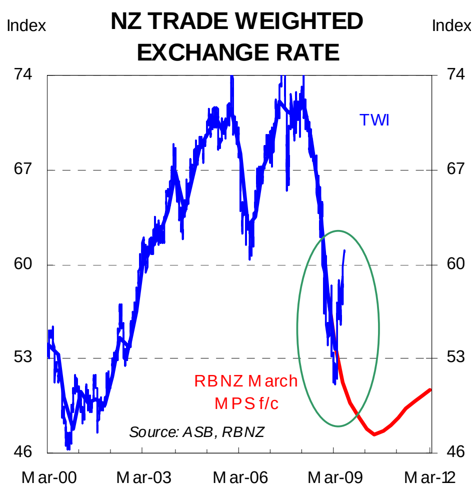
But monetary policy influence swamped by offshore sentiment

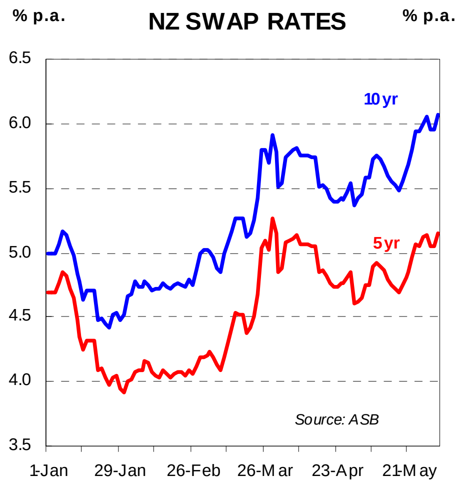
However, since April we have observed that local monetary policy is having very little influence on these markets at the moment. The drivers of recent financial movements have largely come from offshore. The NZ dollar has been lifting on the back of US dollar weakness – in the contest for the worst economic fundamentals NZ is not coming last. Longer-term interest rates have been rising, led by a pick up in longer-dated government bonds. Again the increase has largely come from offshore, as market participants have become more circumspect on the large supply of government debt issuance over the next few years.

April's 50 basis point cut had very little lasting effect against these dynamics, so it's hard to imagine a 25 basis point cut will much impact.









Hold your fire for now

Wait for more opportune times

The RBNZ has delivered the majority of monetary stimulus, and any further small cuts are essentially fine tuning at the margin. Also, taking into consideration the RBNZ only has 50 basis points of OCR cuts left up its sleeve, it might want to save these when it will get greatest bang for buck. If the RBNZ cuts 25 basis points in June, it might be a waste of precious OCR ammo. There may be better opportunities in the future.

Deposit rates sticky

OCR loses traction, deposit rates sticky

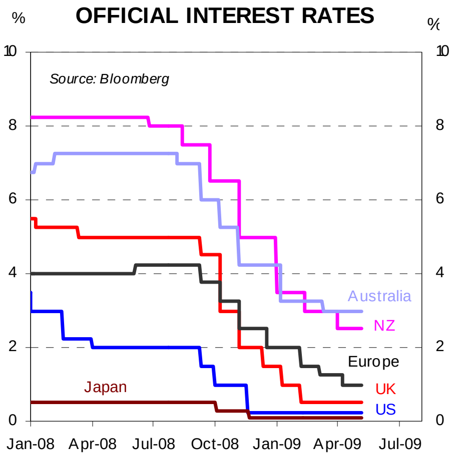
Stickiness in deposit rates is also reducing the effectiveness of OCR cuts. Bank deposits need to compete with alternative investments such as equities, corporate bonds, and finance companies. The limit to how far deposit rates can fall appears to have been hit. Alternative funding sources are either much less dependable or much more expensive. Further more, increasing NZ's dependence on foreign borrowing goes against the grain of every lesson the credit crisis has taught.

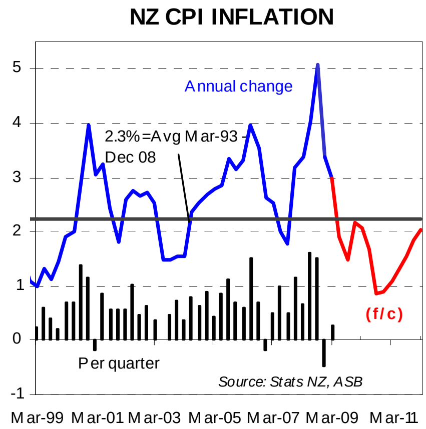
OCR has its limitations

Monetary policy has limitations

One lesson learned from the financial crisis is that conventional monetary policy has limitations. The links between the OCR and other interest rates is not that tight, and under challenging financial conditions other factors can dominate. On the bright side, NZ monetary policy has been much more effective than experienced in other countries, particularly the US. In NZ the majority of OCR cuts have been passed on, and the OCR remains the key tool for monetary policy. In contrast, the US and UK have struggled to get borrowing costs lower and have already resorted to less traditional and more risky measures to ease credit conditions. The OCR still has the potential for some effect under the right circumstances, and will remain the first tool of choice for the RBNZ.

But RBNZ having more success than others





More cuts down the track?

Inflation risks to the downside, more stimulus likely

We expect the RBNZ will keep the cash rate on hold in June. Now is a good time to pause and assess the effectiveness of rate cuts to date, as right now further OCR cuts will achieve little. There have been some promising signs on the economic outlook, although there is a long way to go yet. However, the risks to the inflation outlook remain to the downside and we expect the RBNZ will have to deliver some form of stimulus in the future. For that reason we still envisage an OCR of 2.0%, though it is quite possible the RBNZ does consider some alternative actions.

The June Statement

RBNZ needs dovish tone to anchor expectations

We expect the RBNZ's statement will acknowledge the improvement in confidence and stabilisation in economic activity. We expect the Governor to reiterate the extensive amount of stimulus delivered to date and deliver a firm reminder that the RBNZ expects to hold the OCR at or below current levels until the "latter part of 2010". We would not be surprised if the statement fires a warning shot across the bow of the market, calling current levels of longer-term interest rates and the NZ dollar unwarranted and inconsistent. The RBNZ will need to be very clear with its easing bias, using a tone that leaves the door open to future action to keep market pricing and rate expectations contained. If the RBNZ stays on hold, it needs to be sufficiently dovish to avoid a repeat of its March statement, which triggered a rush to fix borrowing costs. The wildcard risk for the day is the RBNZ takes some step to put downward pressure on both interest rates and the exchange rate.

Special Focus: The effectiveness and risks of alternative measures

Conventional monetary policy has started to lose a lot of its bite. If the RBNZ does at some point want to try adding further stimulus, it may need to step out of the box. We take a brief look at the various alternatives, their chances of success, and the risks involved.

Jawboning

RBNZ can try talk markets down, but talk is cheap

The RBNZ can reinforce that interest rates are likely to remain low for an extended period; that pricing of hikes for early next year is inconsistent with that stance. An effort to talk down the NZ dollar is also quite possible. The effectiveness is likely to be very limited, with any impact short-lived. The implied tightening in short-term interest rates is less about any explicit expectation and more to do with the lifts in long-term rates filtering through to have some impact on the pricing of shorter terms. The issue with trying to talk down the NZD is that the main driver of the stronger NZD is a weaker USD. The only real risk is a lack of lasting effect.

Cutting the OCR

OCR cuts may be futile

The April 50bp OCR cut had little impact on lending rates, and a further cut would also have little impact. Deposit rates have effectively hit the limit of how far they can fall. The rates need to remain competitive enough relative to other higher-risk but higher-return investment alternatives, or else the banking sector's funding base would be eroded. Even just to maintain current lending balances would require either borrowing more foreign short-term money (the least dependable source of funding) or more expensive long-term foreign funding (which would defeat the objective of trying to lower lending rates).

Risk: Right now the RBNZ would effectively achieve as much from cutting the OCR as leaving it on hold, yet use up some OCR ammunition that could be more effective at a future date.

Attempting to push down long-term interest rates

Push down longer term rates – swimming against the tide

Pushing down long-term interest rates would help reduce the cost of long-term funding for banks and have flow-on effects to corporate and business fixed-term debt servicing costs (as well as mortgage rates). Although households might be quite happy to fix for relatively short terms at low rates, many businesses will prefer to spread their maturity risk over time. Also, importantly, the RBNZ is actively encouraging banks to reduce short-term wholesale funding in favour of raising the proportion of long-term funding, but this funding is considerably more expensive. The challenge with trying to drive down longer-term interest rates is that there is a significant amount of debt issuance occurring globally as governments plug deficits, placing upward pressure on long-term rates. Swimming against that strong current might have some effect, but also risks doing no more than delaying the inevitable. Some options are:

Swap markets one option

Receiving in the swaps market: the RBNZ could receive a fixed-term interest payment in return for paying the 90-day bank bill rate, in other words acting as a counterparty to banks' fixed-rate hedging activities. It was the lack of such counterparties in late March/early April that contributed to the spike in long-term rates. The drawbacks are the RBNZ would potentially be exposed to financial loss if entering into long-term (e.g. 3+ year) swaps. 1-year swaps would carry considerably less financial risk, but would not target long-term rates nearly as effectively.

Purchasing bonds another option

Purchasing long-term debt: directly buying corporate or government bonds would, all other things equal, exert some downward pressure on longer-term rates. However, if the purchases were financed by issuing short-term debt the transactions run similar types of risk to entering swap transactions. If the RBNZ created money to pay for the purchases, there is the longer-term risk of creating inflation.

Direct lending to banks

RBNZ could expand use of RBMS facilities

The RBNZ could directly lend to banks by expanding the use of Residential Mortgage Backed Securities (RMBS) as collateral for term loans. Although this option has the double benefits of providing low-cost funding to banks without reducing the quality of banks' funding, the RBNZ is likely to be reluctant to follow. The ability to use RMBS as collateral with the RBNZ was more intended as a back-stop measure in case global credit markets seize up.

FX Intervention to sell the NZD

FX intervention possible, but USD fundamentals challenging

The RBNZ, having unwound its position from its first FX intervention, could again sell the NZD. The risks are currently heavily skewed towards having no lasting effect. The NZD's lift is largely due to the USD weakening, and intervention will achieve little. Ideally the RBNZ would intervene when "the exchange rate has varied in excess of its relevant economic fundamentals". Although, arguably, NZ fundamentals in isolation point to a weak NZD/USD, the problem is the US fundamentals are arguably even more compelling of a weak USD. A key financial risk is that *if* the USD is structurally weak for a number of years, by intervening at current NZD/USD levels the RBNZ runs the risk of sitting on a large unrealised loss for a number of years.

Some background to the event

OCR formally reconsidered every 6-7 weeks

The Reserve Bank of New Zealand (RBNZ) releases a Monetary Policy Statement (MPS) each quarter outlining its thinking about the economy, especially future growth and inflation rates.

At the Statements and at mid quarter Reviews the RBNZ take the opportunity to review the setting of the Official Cash Rate (OCR) target.

The OCR target effectively locks the level of wholesale overnight rates. Other wholesale short-term interest rates change to reflect anticipations of where the OCR might be in the ensuing weeks. In turn, the retail rates set by the banks will adjust to the level of wholesale rates.

Wholesale and retail rates need not adjust in the same direction and magnitude of any OCR change. The reaction will depend on the extent to which the RBNZ action has already been anticipated and built into rates.

While interest rates are a key factor in exchange rate determination, the exchange rate may or may not also respond to changes in the level of short-term rates. Other factors may also come into play at the time.

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