ECONOMICS

11 Jun. 09

Economic Update

RBNZ on hold with hope

Review of June 11th Monetary Policy Statement

- **The OCR remains on hold at 2.5%, RBNZ leaves door open for further rate cuts.**
- **RBNZ continues to expect it will hold the cash rate at or below 2.5% until latter part of 2010.**
- **We continue to expect further cuts to the OCR, although these are dependent on the NZD.**

The Official Cash Rate (OCR) on hold at 2.5%

The RBNZ kept the OCR on hold at 2.5% as we were expecting, in addition the tone of the RBNZ's statement delivered few surprises. The RBNZ acknowledged signs of so-called green shoots, noting international economic activity is stabilising and international financial conditions are improving. The RBNZ also noted the recovery in the housing market and net migration. Nonetheless, the RBNZ continued to emphasise the weak economic outlook and see risks remain weighted to the downside. Inflation pressures are lower then previously expected and CPI inflation is likely to briefly fall through the bottom of the target band later this year.

In our view, the RBNZ's exchange rate assumption is too weak, and leaves the RBNZ vulnerable to the risk inflation falls uncomfortably low. Going forward there are two key influences on the OCR outlook: downside risk to the RBNZ's outlook, but some acceptance that there is little the RBNZ can do about tighter monetary conditions except hope that they abate. We still judge there is some chance of further OCR cuts, but increasingly that likelihood rests on when the RBNZ changes its view on the longer-term outlook for the NZ dollar. That won't happen immediately. We expect another pause in July, and have pencilled in two 25bp cuts in for September and October, although these are heavily dependent on the NZ dollar. Link to RBNZ MPS

RBNZ notes recent stabilisation

Green shoots acknowledged

The RBNZ acknowledged the recent signs of so-called green shoots, noting international economic activity is stabilising and international financial conditions are improving. However, the RBNZ was careful to not get too excited, remaining wary of the uncertainties and continued weak outlook. Nonetheless, the RBNZ noted the increased confidence that activity in NZ and abroad will trough over the next few quarters.

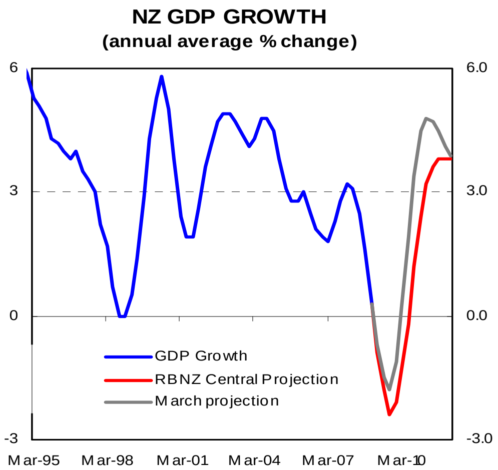
Revises down GDP forecasts

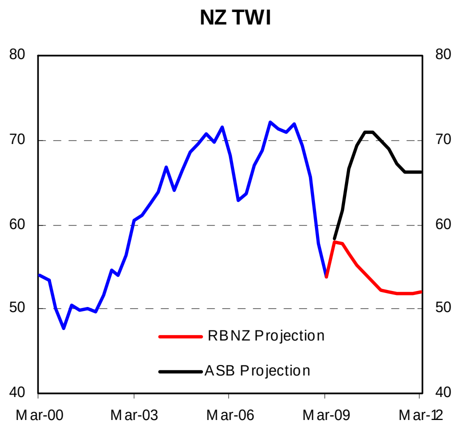
Growth outlook weaker

The RBNZ have now revised down its forecasts considerably compared to its very optimistic March projections. GDP forecasts over the next year are now looking more similar to our own. Nonetheless, we do feel uncomfortable about some of the components of the RBNZ's forecasts, in particular the strength of the recovery in business investment and exports.

Still assumes strong recovery in business investment

Businesses remain under intense pressure with activity falling and profits squeezed. Investment plans are continuing to be cut back and even when activity picks up, businesses are unlikely to be in a position to ramp up investment plans.

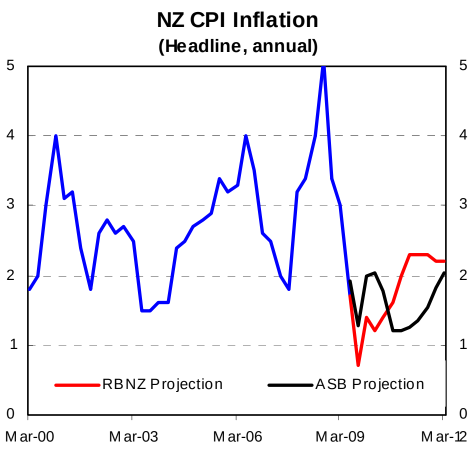




Nick Tuffley – ASB Chief Economist – 649 374 8604 – nick.tuffley@asb.co.nz
Jane Turner – ASB Economist – 649 374 8185 – jane.turner@asb.co.nz

Low TWI assumption underpins export recovery

The RBNZ have a very strong export led recovery over 2010 and 2011, again we remain more cautious. Much of the RBNZ's recovery is hinged on the currency (trade weighted index of NZ main trading partner currencies) to gradually depreciate over the forecast horizon. In our view there is a strong possibility this doesn't happen.



Household outlook comparatively bleak

The RBNZ forecast housing construction will pick up off its lows, but continues to envisage a very weak consumption outlook with falling per-capita consumption.

Inflation risks remain to downside

Inflation pressures lower, risks to the downside

With the weaker growth outlook the RBNZ notes that inflation pressures are now lower than previously expected. Indeed, the most recent CPI outturn suggests non-tradable inflation is abating faster than expected. Also wage inflation pressures are easing rapidly, reflecting the deterioration in the labour market. The RBNZ expects that CPI inflation will fall through the bottom of the target band, but will then return inside the band and remain there 'comfortably' throughout the projection horizon. In our view we continue to see strong downside risks to inflation. Our medium-term inflation forecasts are weaker than the RBNZ's, remaining closer to 1% for longer. Inflation pressures are abating rapidly, and inflation expectations are likely to follow. In addition the RBNZ currency projection leaves them vulnerable to further downside surprises on the inflation outlook.

Weak currency Achilles heel of forecasts

Weak currency assumption, downside risk to inflation

The RBNZ seems adamant the exchange will continue to depreciate to low levels over 2011. Even in the Bank's 'stronger currency' scenario, the TWI still depreciates back to around 54 cents over the medium term. Granted, currency forecasts are extremely hard to get right, and the uncertainties now high. For horizons greater than one year the uncertainties are always very large. That is why economists tend to make conservative projections for currencies to revert to long-term assessments of fair value, reflecting the outlook for relative credit ratings, growth, inflation, and interest rates. Our currency forecasts include a weak US dollar given risks to the US sovereign outlook, and the weak US growth outlook. This has generated a higher AUD & NZD forecasts. The RBNZ assumption of a very weak medium-term NZ TWI skews the risks to the RBNZ's forecasts strongly one way. If the currency remains at current levels on the back of US dollar weakness (which is our core scenario), inflation pressures are likely to be weaker than the RBNZ is assuming, and monetary conditions will be tighter for the export sector. Easier monetary conditions will have to be delivered via lower interest rates – which is why we expect the next move in the OCR to be a cut, not a hike.

No attempt to swim against the tide

RBNZ pragmatic on financial conditions

The RBNZ acknowledged the tightening in monetary conditions over recent months via the higher NZ dollar and long-term rates. The RBNZ notes that much of the drivers are from overseas. Critically, the RBNZ seems resigned to these developments – there is little evidence of any desire to directly combat them.

Reluctant to use alternative tools

As we discussed in our Preview, many of the potential unconventional actions the RBNZ could take have a lot of fishhooks and won't necessarily achieve much. The RBNZ has again expressed reluctance to use them. Even the Bank of England and the Federal Reserve are having to endure rising long-term interest rates despite their Quantitative Easing measures.

The RBNZ's main response to tighter conditions seems to be holding the OCR low for extended period, as it has implied in its April and June statements. The threshold for trying to directly influence long-term rates is very high. Moreover, the acknowledgement that offshore factors are behind the NZD rise would rule out FX intervention (moreover, despite the recent rise, the NZD/USD is not that much above average levels as makes intervention financially risky).

OCR still main tool

The RBNZ still places faith in OCR's ability to influence market rates, noting that there is still potentially 250bp the OCR can theoretically fall. It is the case in NZ that dropping the OCR has triggered substantial drops in lending rates, in contrast to countries at the coal face of the credit crisis. But the April 30 OCR cut demonstrated the OCR has lost a lot of its impact now that it is very low. The stark reality is that domestic funding costs are being driven by households' willingness to keep money in the bank instead of some riskier alternative.

Implications: further OCR cuts not ruled out quite yet

NZ dollar key risk to RBNZ's outlook

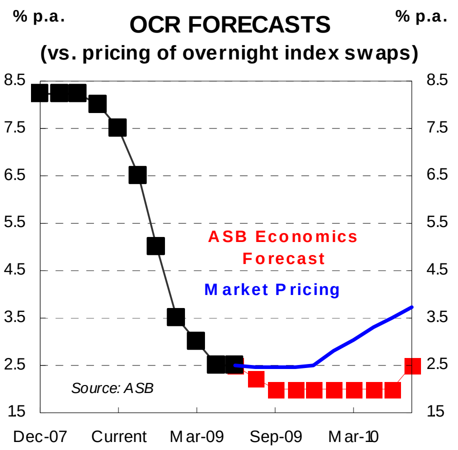
Going forward there are two key influences on the OCR outlook: downside risk to the RBNZ's outlook, but some acceptance that there is little the RBNZ can do about tighter monetary conditions except hope that they abate.

Even though the RBNZ has revised its growth and inflation forecasts down once again, there remains a risk of the recovery being slower than the RBNZ anticipates – and a stronger risk of inflation being uncomfortably low. The primary source of risk is that a stubbornly-high NZ dollar against certain currencies, rather than subsiding as the RBNZ assumes. The RBNZ's projections owe a fair amount to improved exports and high imported inflation through a low NZ dollar. Over time we see that outlook being challenged, but not immediately given the RBNZ is aware the NZ dollar could remain elevated in the short term.

Downside risk to inflation may prompt further cuts

Whilst potential for further easing remains, it is also clear that the RBNZ is not going to directly respond to the tighter monetary conditions. Consequently, the threshold for further OCR cuts is higher than we previously envisaged.

We still judge there is some chance of further OCR cuts, but increasingly that likelihood rests on when the RBNZ changes its view on the longer-term outlook for the NZ dollar. That won't happen immediately. We expect another pause in July, and have pencilled in two 25bp cuts in for September and October. Although we think future cuts will have less impact than the RBNZ seems to, our view of an upward trend for the NZD/USD suggests the RBNZ will eventually feel a greater urgency to respond. But, further OCR cuts or not, short-term rates are highly likely to remain low over the next year whilst long-term rates remain high and possibly rise further.



Market Reaction

NZD and interest rates lift on statement

The market response to the relatively optimistic assessment from the RBNZ was to be expected – the NZD lifted, and swap rates rose. The NZD has lifted over half a cent against the USD, and is trading around 0.633 at the time of writing, nearly 1 cent above the overnight lows. 90-day bank bills are little changed, and consistent with the RBNZ remaining on hold over the coming months. However, swap rates have increased around 10 basis points, and are likely to remain under upward pressure today. Market pricing in the OIS market is also consistent with the RBNZ remaining on hold over the coming months. The market is only pricing a 10-15% probability of a cut from the RBNZ at the next meeting in July, and has hikes priced in over the next 12 months. Longer-term OIS pricing is likely more of a reflection of the upward pressure on swap rates at present, rather than a clear assessment of the RBNZ's 2010 moves. However, the market is less convinced than the RBNZ that the OCR will remain on hold until the latter part of 2010

Markets less convince RBNZ will remain on hold over 2010

	8.50 am	10.50am
NZD/USD	0.6268	0.6331
NZD/AUD	0.7803	0.7893
NZD/EUR	0.4483	0.4529
NZD/JPY	61.51	62.14
NZD/GBP	0.3831	0.3869
AUD/USD	0.8035	0.8022
NZ 90 day bank bill	2.72	2.73
NZ 1 year swap rate	2.88	2.97
NZ 3 year swap rate	4.34	4.46
NZ 5 year swap rate	5.13	5.24

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.

RBNZ NEWS RELEASE

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."

http://reports.asb.co.nz/index.html

ASB ECONOMICS & RESEARCH			PHONE	FAX
Economics				
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 374 8604	(649) 302 0992
ASB Economist	Jane Turner	jane.turner@asb.co.nz	(649) 374 8185	
CBA NZ Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 374 8819	