

# Looking to the recovery

RBNZ June MPS: OCR unchanged at 2.50%, reiterates no tightening before late 2010

- The RBNZ left the OCR unchanged, acknowledging that growth remains fragile but with early signs of recovery in the global economy and stronger migration and housing activity at home.
- The statement reiterated that short-term interest rates are expected to remain very low for the foreseeable future.
- The stronger NZ dollar remains a concern, but the issue is whether it portends a return to economic imbalances.
- We expect the RBNZ to remain on hold at the July review.

The RBNZ left the cash rate on hold at 2.50% in today's *Monetary Policy Statement*, which was seen by financial markets and most domestic forecasters as the most likely outcome. The RBNZ repeated the message from the April OCR review that further modest rate cuts are possible (though apparently not their central view), and that the cash rate is expected to remain at or below the current level until late 2010.

The RBNZ noted that the economic outlook is weaker than in their March forecasts, and with substantial risks to the downside. But they seem to now be more convinced by the extent and sustainability of the 'green shoots' in the economy, in the form of a stabilisation in activity indicators offshore (particularly in Asia) and a pickup in housing and net migration in New Zealand. In fact, a large portion of the MPS was devoted to exploring the extent and sustainability of the eventual recovery. This focus on the next upswing might seem premature, but it's consistent with the RBNZ's focus on activity and inflation pressures one to two years ahead.

It's important to note that increased confidence about activity doesn't mean that the RBNZ are turning hawkish on inflation. Their forecasts see GDP running at more than 4% below potential over the next year, and even with strong growth in later years, the economy isn't expected to close this gap before the end of the forecast period in early 2012 (*Figure 1*). Rising unemployment and lower capacity utilisation mean that the RBNZ is a long way from having to worry about any substantial

inflation pressures building in the domestic economy. The RBNZ lowered its near-term inflation forecasts compared to March, and now expect annual inflation to remain below 2% until the end of 2010 (*Figure 2*).

Figure 1: GDP

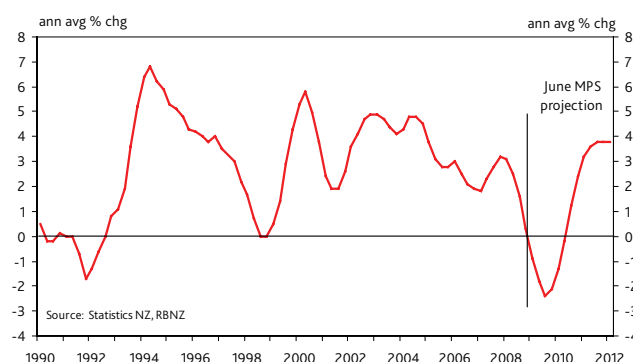
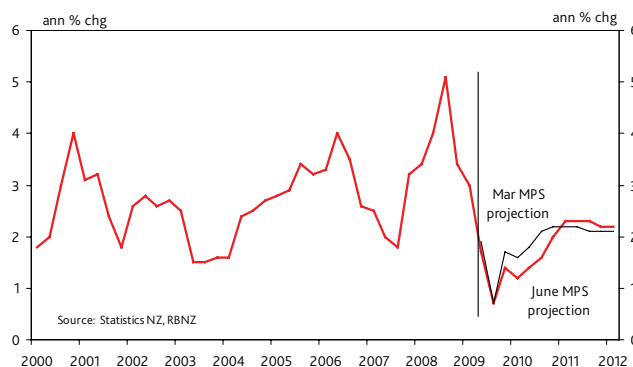


Figure 2: CPI inflation



The RBNZ's interest rate projections were markedly different from the March MPS (*Figure 3*). The 90-day rate is expected to remain around the current level of 2.8% until late 2010 – which they have said as much in the last two OCR reviews – and indicates that their central view is for no further cuts this year. But the more notable change was that the following tightening cycle is expected to be extremely slow, with 90-day rates only reaching 4% by early 2012.

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Figure 3: 90-day interest rate

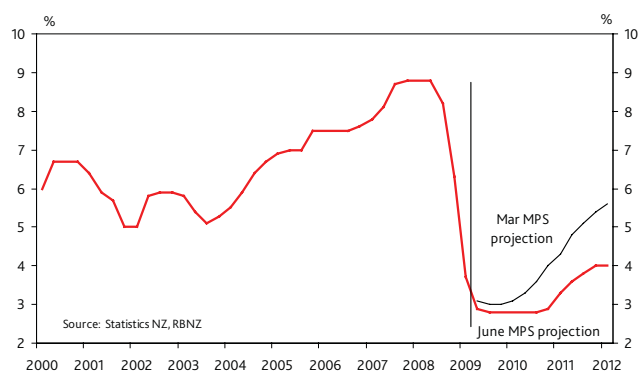
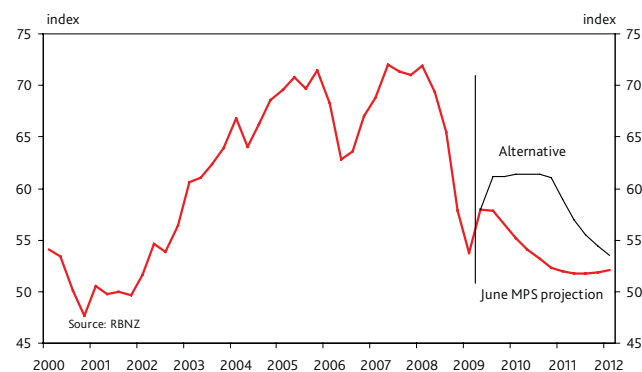


Figure 4: Nominal TWI



This is clearly a message aimed at financial markets, in order to keep a lid on short-term wholesale rates – the RBNZ is looking to borrowers to fix for terms of a year or less, where rates are significantly lower than for longer terms. The press release also noted that “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” – a statement that serves double duty as a nudge to banks to pass on more of the recent OCR cuts, and as a reminder to borrowers that short-term fixed rates are much cheaper at the moment and will remain so for some time.

The strength of the New Zealand dollar remains a bugbear for the RBNZ (although strength is a relative term, as the trade-weighted index is still slightly below its long-term average). While the RBNZ believes that some of the rise in the currency reflects a genuine increase in export demand, they are concerned that the market is placing too much focus on international trends and too little on domestic conditions – such as fragile growth, falling terms of trade and a large current account deficit – which in the RBNZ’s view warrant a weaker currency.

As we noted in our preview, the issue is whether the market is overestimating the recovery in global demand. If there is a genuine rise in export demand on the way, then by nature it won’t snuff itself out through a higher exchange rate. And if the market is too optimistic, it’s unlikely that the NZD’s gains will be sustained for long.

The RBNZ’s big fear, as spelled out in an alternative scenario in the *MPS*, is that the recovery manifests as a return to the imbalances that have plagued the economy in recent years: rising house prices driving an increase in household spending, while a stronger currency hammers the export sector (Fig 4). We think it’s a valid concern, since little has happened during the credit crunch to alter the relative appeal of borrowing versus saving – and record low interest rates for the foreseeable future certainly wouldn’t help. While the RBNZ didn’t publish an interest rate forecast for this alternative scenario, we can take it from experience that they would be hiking rates earlier and faster, not cutting further, in this environment.

### Market implications

Unfortunately for the RBNZ, the market seems to have decided that their very low interest rate projections strain credibility, and instead has latched on to the talk of recovery. The one-year swap rate has risen by 9 basis points, while two- to five-year rates have risen by 20-25 basis points. The RBNZ faces a difficult task in managing interest rate expectations at this point in the cycle, but we doubt that they would see any benefit in cutting rates again simply as an attempt to ‘send a message’ to the market.

We expect the RBNZ to remain on hold again at the July OCR review. For now, we are maintaining our pick for further cuts later this year, reflecting our view that the global recovery still has some major hurdles to overcome: weak household balance sheets, vulnerable banking systems (particularly in Europe) and rising long-term interest rates. However, if the NZD moderates its gains, or global demand improves faster than expected, the RBNZ will be on hold from here.

### Monetary Policy Statement June 2009 – Policy Assessment

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

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.

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