

24 August 2009

The Cons of Currency Union with Australia

- Will New Zealanders adopt the Aussie dollar?
- Not as far as we can see it
- Tuesday's RBNZ survey to signal higher NZD
- We see a July trade deficit of \$635m
- Building consents, credit aggregates, likely good and bad

There are never any perfect exchange rate set-ups. If there was, the choice would be straightforward. In reality, each has important pros and cons. Because of this, any country's currency regime should regularly be up for negotiation. And we can understand the intense discussion at the moment, with the robust NZ dollar already, and expectations on the up, hardly conducive to a traditional export-led recovery.

However, the recent debate about New Zealand going into a currency union with Australia has rather unfortunately been over-playing the pros relative to the major cons, in our opinion. We need the debate to shift beyond the self-appointed experts in the media.

The pros, of course – as with almost any currency union argument – principally relate to micro-economic efficiencies. A fixed exchange rate would quite simply remove conversion uncertainty and transaction costs between two nations with much in common and plans for even closer integration. The NZ dollar would get all the "protection" of joining forces with a much bigger cousin. Sounds like a no-brainer.

Unfortunately, it's nothing of the sort.

Even in respect of the "stability" provided by currency unions we need to debunk a few myths. For a start, while the New Zealand dollar does move around quite a bit, it is not noticeably more volatile than any other currency. All floating currencies trace choppy cycles. One need only look at how the US dollar, the Euro, the Yen and the British Pound have traded amongst themselves over any length of time to see that size does not guard against big swings.

And in the case of the Australian dollar, let's not forget it fell to about 60 US cents last October, from near 98 cents in July, to now be back up at around 84 cents. Does this mean the Australian dollar should go into a currency union with the US dollar?

The Euro has added lessons, from a policy point of view. Its adoption by member states was driven by a strong political agenda, and initially by the bigger nations of

Europe (the economics for currency union was far from cut and dried). Pity, now, some of the smaller countries that jumped in. They have been some of the worst affected by the Euro's recent relative strength. Many would now arguably be in much better shape had they not joined the common currency to begin with. Countries like Ireland, Portugal, Greece and Spain.

This is reminder that every country has distinct characteristics, structures and abilities to cope – whether European countries within Europe, Asian countries with Asia, or Latin American countries within Latin America.

In this respect, the main trouble with currency unions is that they extinguish a nation's ability to set its own interest rates and control one's domestic money supply. Decisions on these are devolved to a centralised power.

In the case of any currency union with Australia, New Zealand's monetary policy would effectively be run by the Reserve Bank of Australia. In theory, the RBA should pay full regard to New Zealand's circumstances if it was ever to end up setting Australasian monetary policy. However, the reality is that the GDP, inflation, and financial system conditions of the much bigger Australian economy would dominate, leaving New Zealand to simply hope for the best.

Of course, there are many who conclude that the New Zealand economy is so closely entwined with the Australia's – including via banking – that it's all part of the one big unit anyway. While this is true, and could well become truer over time, we seem different enough for it to matter in respect of the currency debate.

And we need only look at the last twelve months to see this. Australia is about hard commodities such as base metals and energy – whose prices have rebounded materially this year – while New Zealand is a comparatively more open economy all about exporting soft commodities, mainly food products, and with dairy prices still down around recent lows.

As bad as these relativities might seem at the moment, currency union advocates would make them worse. They're essentially arguing the NZ dollar should move up another 5% or so, as of today, as this is the shift implied by the NZ dollar linking with Aussie at around Purchasing Power Parity ("fair value"), which most judge around 85 cents, or just above. Such a linking, of course, would immediately put NZD/USD above 0.7000, as one

example. We can't have our cake and eat it too. Currency unions mean taking the rough not just the smooth.

Perhaps the biggest obstacle to currency union with Australia, however, will be political. Not so much directly from the politicians, but from the New Zealand populace realising that it effectively means adopting the Australian dollar holus bolus. Requiring Australians to create an ANZAC currency would be like asking New Zealanders to switch to a South Pacific dollar on any proposals for the Pacific Island nations going into a currency union with New Zealand.

Put another way, a currency union with Australia would be like dissolving the All Blacks to create an Australasian rugby union. There are obvious advantages, in creating a stronger team, with fewer passport dramas, but issues of sovereignty would surely reign supreme. Long live the debate on currency union with Australia, we say.

As for less emotive, and more immediately important, issues, the domestic data flow kicks off this week with Tuesday's RBNZ survey of market expectations. With much less focus, now, on its inflation expectations, attention will no doubt turn to the survey's view on GDP, and especially, the NZ dollar. Will it project the clear moderation in the NZ dollar the RBNZ assumed in its previous forecasts? We think not. Indeed, an even more "robust" currency is probably the projection.

For Thursday's merchandise trade figures, we see less juice in exports (\$2,917m, -15% y/y), but more bounce in imports (\$3,552, -16% y/y), compared to market expectations. So, on balance, the \$635m deficit we expect for the month of July is wider than the \$200m shortfall seen by the market's median. Still, it would take a much more negative number to spoil the trend improvement in the annual trade deficit, which already signals a much reduced current account deficit figure at its next release (22 September), or even our assumption Q3 GDP will expand a bit.

July's building consents, due Friday morning, are surely, this time, going to point to an uptrend in residential consents (we anticipate a 10% bounce in number), but will also highlight counteracting weakness in core non-residential consents.

Friday afternoon's credit aggregates close out the week. We expect them to re-establish a moderately improving trend in household credit, including for mortgages (following June's strange stalling), but with further clear slowdown in business credit and a sharp deceleration in borrowing in the agricultural field, relating mainly to the predicament of the dairy sector.

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Domestic Interest Rates

NZ interest rates fell last week, dragged down by the moves seen offshore. The short end of the rates curve is pretty much unchanged. It's consistent with a small chance of a rate cut over the next 2-3 months, but the first hike is fully priced by early 2010. While the aggressiveness of the hiking cycle priced by the market has varied significantly, these general themes have been constant for some time now.

With little in the way of NZ data, and limited client interest, the NZ bond market has been taking its cues from the Australian market. However, short-dated NZ bonds look a little expensive and so they are tending to underperform on rallies and push up faster on sell-offs. This looks likely to continue this week.

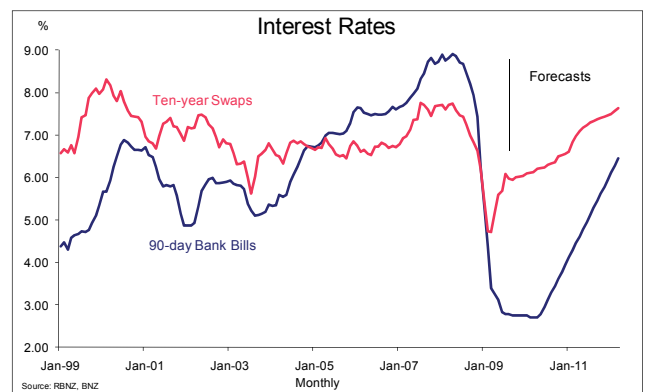
NZ swap rates also nudged lower last week, following offshore moves. The 2-yr swap has really just been

| | 90 day bills | 11/11 NZGS | 12/17 NZGS | 2yr swaps s/a | 10yr swaps s/a | 2yr/10yr swaps(bps) |
|---------------------|--------------|------------|------------|---------------|----------------|---------------------|
| 14-Aug-09 | 2.79% | 4.03% | 5.90% | 4.17% | 6.08% | 191 |
| 21-Aug-09 | 2.76% | 3.98% | 5.74% | 4.03% | 5.94% | 191 |
| Change (bps) | -3 | -5 | -16 | -14 | -14 | 0 |

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trading water in a 4.00-4.20% range. This range trading looks likely to continue near-term. However, markets are mindful that the high NZD may provoke an RBNZ rate cut and swap rates may nudge lower in the lead up to the Monetary Policy Statement on 10 September.

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Interest Rate Technicals

NZD 5yr Swap Rate

Outlook: Consolidation
 ST Resistance: 5.48%
 ST Support: 5.15%

The short-term range is in place and we look to trade a break of either. Our previous view of a break higher still seems the more likely scenario and we are very near that level now.



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NZ 2yr-5yr Swap Spread (yield curve)

Outlook: Steepening
 ST Support: +122

The market has taken a breather here, but has not pulled back far. Therefore, we expect the steepening trend to continue.



Foreign Exchange Market

It has been a topsy-turvy week for NZD/USD.

Early in the week, lacklustre US consumer confidence data and heavy losses in Chinese equities ignited concerns about the strength and timing of the global economic recovery. As risk aversion escalated, "safe-haven" demand for the USD saw NZD/USD knocked below 0.6650.

However, these concerns were assuaged later in the week following more promising economic data and upbeat comments from officials. US home sales surged to the highest level in almost two years and the latest European PMIs showed manufacturing activity continues to run above expectations. The positive sentiment was reinforced by Fed Chairman Bernanke, who noted "...economic activity appears to be levelling out...prospects for a return to growth in the near-term appear good." The upbeat comments and better-than-expected data catapulted US stocks to their highest close in 10 months, up around 2% for the week. Firming global equities and revived risk appetite propelled growth sensitive currencies higher and NZD/USD finished the week a touch below year-to-date highs around 0.6850. The strength in NZD/USD was also underpinned by patches of demand for NZD/AUD, which flirted with 0.8200 (a four month high) late on Friday.

For the week ahead, the fortunes of the NZD/USD will remain closely tied to global investor sentiment. With the

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international data calendar reasonably light this week, the focus will likely remain on global equities as a gauge of investor risk appetite. While global equity markets continue to rally, commodity prices continue to firm and risk appetite remains buoyant, we'd expect the NZD/USD to stay supported on dips towards 0.6650-0.6700.

The important question is whether or not investors think the global backdrop has improved sufficiently to see NZD/USD break into fresh ranges. There are plenty of risks out there – many equity markets are still over-stretched relative to valuations, China is still a worry and US interest rates have risen sharply. It's also worth noting, NZ interest rates nudged lower last week and NZ-US interest rate spreads contracted sharply – defying the move higher in the currency.

However, we think downward pressure is likely to remain on the USD in the near-term as evidence that the global economy is recovering continues to mount. While markets will no doubt get carried away at times, bouts of risk aversion will remain relatively short-lived in our view. As such, a re-test of the year-to-date lows around 77.50 on the USD index looks likely for this week. In this environment, the NZD/USD could eventually push up towards 0.6900-0.6950, although we expect some initial headwinds around the year-to-date high of 0.6880.

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Foreign Exchange Technicals

NZD/USD

Outlook: Consolidation
 ST Resistance: 0.6885 (ahead of 0.6950)
 ST Support: 0.6645 (ahead of 0.6590)

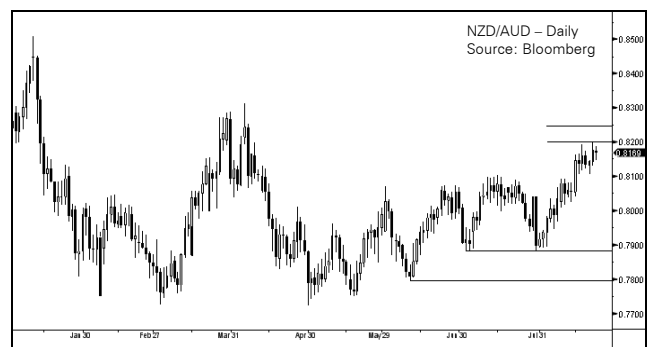
The uptrend is starting to look exhaustive and a failure to break above 0.6885 would portend a correction back towards 0.6650. However, a break below the 12 August low of 0.6590 is needed to suggest the downtrend is gaining traction.



NZD/AUD

Outlook: Sell a rally
 ST Resistance: 0.8195 (ahead of 0.8250)
 ST Support: 0.7890 (ahead of 0.7790)

The convincing break above 0.8100 saw momentum indicators turn bullish. With the daily RSI not yet in "oversold" territory, we'd prefer to wait for bounces above 0.8200 before entering shorts.



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Key Upcoming Events

| | Forecast | Median | Last | | Forecast | Median | Last |
|--|----------|---------|---------|--|----------|--------|--------|
| Monday 24 August | | | | Thursday 27 August | | | |
| Euro, Industrial Orders, June | | +1.8% | -0.2% | UK, Business Investment, Q2 1st est | | -3.6% | -7.6% |
| Tuesday 25 August | | | | UK, CBI Dist Trade Surv, August | | | -15 |
| NZ, Marketscope Inflation Survey, Aug (1-yr ahead) | | | +3.5% | Euro, M3, July y/y | | +3.2% | +3.5% |
| NZ, RBNZ Survey of Expectations, Aug (2-yr ahead) | | | +2.2% | US, Jobless Claims, week ended 22/08 | | 563k | 576k |
| UK, BBA Home Loans, July | | 38k | 35k | US, GDP, Q2 saar 2nd est | | -1.4% | -1.0%P |
| US, Consumer Confidence, August | | 47.6 | 46.6 | US, Fed's Lacker Speaks, Economy | | | |
| Germ, GDP, Q2 2nd est | | +0.3% | +0.3%P | Friday 28 August | | | |
| Wednesday 26 August | | | | NZ, Household Credit, July y/y | | | +2.4% |
| Aus, Building Work Done, Q2 | flat | -3.0% | -3.7% | NZ, Building Consents, July (res, #) | +10.0% | | -9.5% |
| Jpn, Merchandise Trade Balance, July | | +¥385b | +¥508b | Jpn, Household Spending, July y/y (real) | | -0.6% | +0.2% |
| US, Durables Orders, July | | +3.0% | -2.5% | Jpn, Unemployment Rate, July | | 5.5% | 5.4% |
| US, New Home Sales, July | | 390k | 384k | Jpn, CPI, July y/y | | -2.2% | -1.8% |
| US, Fed's Lockhart Speaks, Economy | | | | UK, GDP, Q2 2nd est | | -0.8% | -0.8%P |
| Germ, IFO Index, August | | 89.0 | 87.3 | UK, Index of Services, June 3m/3m | | | -1.0% |
| Thursday 27 August | | | | Euro, Economic Confidence, August | | 78.0 | 76.0 |
| NZ, Merchandise Trade, July | -\$635m | -\$200m | -\$417m | US, Mich Cons Confidence, August 2nd est | | 64.0 | 63.2P |
| Aus, Private New Capex, Q2 | -5.0% | -5.0% | -8.9% | US, Personal Spending, July | | +0.2% | +0.4% |

Historical Data

| | Today | Week Ago | Month Ago | Year Ago | | Today | Week Ago | Month Ago | Year Ago |
|------------------------------|-------|----------|-----------|----------|--------------------------|--------|----------|-----------|----------|
| CASH & BANK BILLS | | | | | FOREIGN EXCHANGE | | | | |
| Call | 2.50 | 2.50 | 2.50 | 8.00 | NZD/USD | 0.6849 | 0.6743 | 0.6563 | 0.7088 |
| 1 mth | 2.78 | 2.80 | 2.78 | 8.28 | NZD/AUD | 0.8169 | 0.8134 | 0.8014 | 0.8171 |
| 2 mth | 2.80 | 2.80 | 2.79 | 8.26 | NZD/JPY | 64.63 | 63.84 | 62.16 | 77.95 |
| 3 mth | 2.77 | 2.73 | 2.74 | 8.18 | NZD/EUR | 0.4774 | 0.4762 | 0.4612 | 0.4793 |
| 6 mth | 2.85 | 2.85 | 2.82 | 8.03 | NZD/GBP | 0.4150 | 0.4093 | 0.3989 | 0.3828 |
| GOVERNMENT STOCK | | | | | NZD/CAD | 0.7392 | 0.7435 | 0.7125 | 0.7429 |
| 11/11 | 4.04 | 4.01 | 3.83 | 6.18 | TWI | 63.59 | 63.00 | 61.42 | 66.09 |
| 04/13 | 4.94 | 4.94 | 4.77 | 6.17 | NZD Outlook | | | | |
| 04/15 | 5.40 | 5.42 | 5.28 | 6.11 | | | | | |
| 12/17 | 5.80 | 5.86 | 5.77 | 6.09 | <p>Source: BNZ, RBNZ</p> | | | | |
| 05/21 | 6.23 | 6.32 | 6.53 | - | <p>Monthly</p> | | | | |
| CORPORATE BONDS | | | | | | | | | |
| BNZ 09/10 | 3.84 | 4.05 | 4.02 | - | | | | | |
| BNZ 05/15 | 6.71 | 6.91 | 7.06 | - | | | | | |
| GEN 03/14 | 6.69 | 6.85 | 7.34 | - | | | | | |
| GEN 03/16 | 7.18 | 7.33 | 7.66 | - | | | | | |
| TRP 12/10 | 4.56 | 4.72 | 4.58 | 7.47 | | | | | |
| TRP 06/20 | 7.67 | 7.83 | 7.74 | 7.46 | | | | | |
| SWAP RATES | | | | | | | | | |
| 2 years | 4.08 | 4.15 | 3.93 | 7.31 | | | | | |
| 3 years | 4.77 | 4.83 | 4.66 | 7.15 | | | | | |
| 5 years | 5.40 | 5.45 | 5.36 | 7.03 | | | | | |
| 10 years | 5.99 | 6.05 | 6.02 | 6.95 | | | | | |

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