Weekly Commentary

5 July 2010

Dear prudence

Last week the RBNZ said that its top priority for the next year is to investigate the potential use of macro-prudential policy tools. What does this mean, and how does it fit with their existing roles?

The RBNZ has two main functions where both the ends and the means are fairly well defined. The first is price stability, which is (currently) defined as maintaining inflation at 1-3% on average over the medium term. The RBNZ follows an 'output gap' framework: inflation pressures rise when economic activity is running above its long-run potential, and vice versa. Therefore, managing the level of output, via interest rates, equates to managing the inflation rate. The second role is finance sector stability, which relies on a mix of rules and oversight to ensure that each individual bank is being run prudently and doesn't present a risk to the wider financial system.

The additional role of macro-financial stability is more fuzzily defined, and tends to fall into the gaps that can arise in the first two functions. For instance, in the last decade, many developed countries saw rapid money supply and credit growth. But whereas in the past this would have been associated with rapid inflation, that didn't happen this time – at least, not under the narrow definition of consumer price inflation. There was, however, rapid asset price inflation, which led to rampant speculation and rising leverage that left many exposed when the global financial crisis hit.

In hindsight, what could policymakers have done to prevent this? From a monetary policy perspective, central banks could have raised interest rates much further to squelch the demand for credit. But that would have also suppressed growth by more than their price stability role would have warranted, and could even have led to outright deflation in consumer prices (which has its own problems, as Japan has shown). From a banking point of view, there was no sign that individual banks were acting recklessly, and no-one had responsibility for the total level of debt in the system. Hence the interest in macro-prudential policy: tools that could address particular threats to the wider financial system, without undesirable side effects.

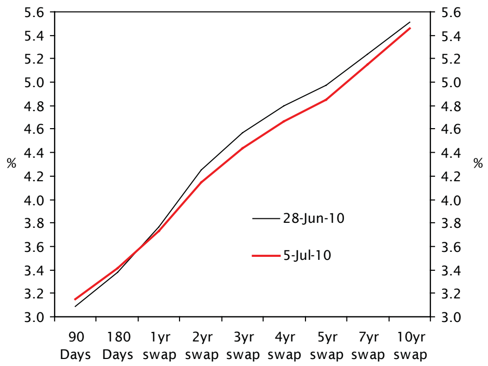
Sounds good – but after more than a decade of investigation, there is still no agreement on which tools are appropriate, or how they should be used. For one, it's debatable whether they really represent an alternative to monetary policy; most of them involve restricting the supply of credit, which inevitably puts upward pressure on the interest rates faced by borrowers. Another issue is that many of them work on paper, but are very difficult to apply in real time.

In a Bulletin article published last week, the RBNZ highlighted two particular measures that it is considering using in a more active way: capital adequacy requirements and prudential liquidity ratios. Both of these are already in use in New Zealand, at fixed levels that apply throughout the economic cycle.

There is a sound basis for both measures, in terms of banking stability. Setting a minimum level of capital prevents banks from engaging in a 'race to the bottom', undercutting each other by operating on an ever-decreasing capital base. The RBNZ's core funding ratio limits banks' reliance on short-term wholesale funding, which has to be continuously replaced – fine as long as markets remain functioning, which didn't happen during the financial crisis.

Whether these measures serve a role as automatic stabilisers is questionable. Bank capital rules were aimed at standardising the minimum level of capital across all banks; there was no pretence that this was the 'right' level of capital. Indeed, it's not even clear that there is a 'right' level that would subdue the credit cycle. For instance, US bank capital ratios were about twice what they are today – and rising – in

NZ Interest Rates



**Yield curve is yields on bank bills to 180 days, fixed interest rate swaps for 1year onwards.*

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the years before the Great Depression. The core funding ratio has yet to be tested over a full cycle, but our analysis suggests it will have offsetting effects: borrowing rates will be more sensitive to demand, but less sensitive to OCR changes.

The RBNZ has raised the idea of taking these measures one step further and using them actively as policy levers to manage the credit cycle, as a complement to monetary policy. Frustratingly, the debate so far has been limited to how they could be used to moderate the 'boom' phase of the cycle, easing back when conditions return to 'normal'. But a cyclical policy tool needs to be effective over the entire cycle – including downturns. And for macro-prudential tools, that's where the real problems arise.

First, let's take bank capital requirements. The aim is to force banks to build up a capital buffer during the boom times, then run it down in a recession. That's fine, as long as you know in advance how long and deep the downturn is going to be. But if a bank burned through its capital buffer before the downturn had ended, it may have to reverse course and raise capital, or shrink its balance sheet, at the very point that this would be most harmful to the economy. What's more, even if the banking regulator approved of a bank eroding its capital when it is most needed, we imagine that markets and rating agencies would take a dimmer view.

The core funding ratio is even more problematic, because it doesn't work symmetrically. Increasing the ratio during a boom would force banks into longer-term, more expensive sources of funding, which would be quite effective in raising interest rates and slowing credit growth. But it's much harder to push banks back into short-term funding during a downturn. They could only move at the rate at which their existing funding matures – which itself will be more drawn-out as a result of the core funding rules.

Nobody has suggested that macro-prudential tools are a 'silver bullet' for managing booms. But we're more concerned about the lack of analysis on how they might operate during busts.

Fixed vs. floating: This month, as was widely anticipated, the RBNZ kicked off what we expect to be an extended tightening cycle. Nevertheless the decision to fix or float remains finely balanced. Floating rates remain lower than short-term fixed rates at the moment, but they are likely to rise faster as the RBNZ increases the OCR. Fixing, if even for a short term, has the advantage of greater certainty around cash flows, at a time when floating rates could be rising rapidly. Repaying more than the minimum amount, and spreading the loan over a mix of terms, can also help to reduce the overall risk around uncertain future interest rate changes.

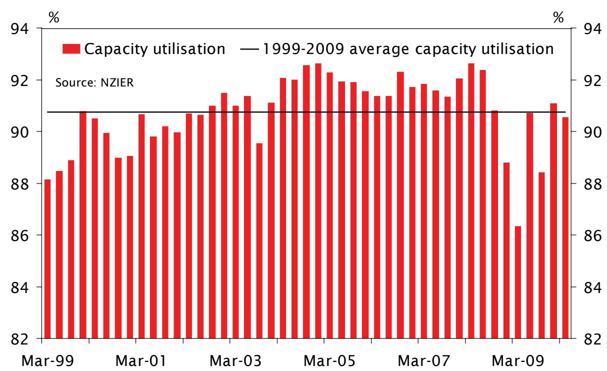
Key Data Previews

NZ Q2 NZIER business confidence

Jul 6, Last: 22%

- The March *Quarterly Survey of Business Opinion* saw a further surge in confidence to new cycle highs, suggesting that the recovery was accelerating. However, this wasn't quite substantiated in the Q1 GDP figures, with 0.6% compared to 0.9% in Q4.
- The monthly business survey remains at high levels but dipped lower in June, perhaps in response to the tax changes in the May Budget and/or shakier global markets.
- Pricing and inflation expectations are likely to spike higher as a result of policy changes such as the ETS and the GST increase. Capacity utilisation may also be affected, since the survey question is posed in terms of unit costs.

QSBO capacity utilisation

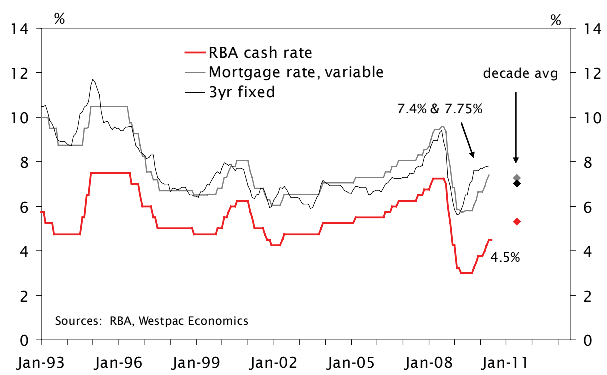


Aus RBA policy announcement

Jul 6, Last: 4.50%, WBC f/c: 4.50%, Mkt f/c: 4.50%, Range: 4.50% to 4.50%

- The cash rate was held at 4.50% in June, with the Statement focussed on the global economy. It concluded describing the "setting of monetary policy as appropriate", qualified with "for the near term", to us a hawkish qualification with growth forecasts for the next two years above-trend, unemployment nearing the NAIRU, and core inflation still at the top of the target band.
- No rate change is expected this month, with growing concerns over the global outlook and the risk of contagion from European turmoil via confidence, and credit costs and supply.
- Inflation trends are important, with a 'high' Q2 core CPI read disturbing if the RBA still expects above-trend Australian growth.
- We will be scrutinising the Statement to see if the Bank is lowering its Australian growth forecasts to below-trend, buying time to leave rates at 'neutral' for longer.

RBA: rates have been normalised

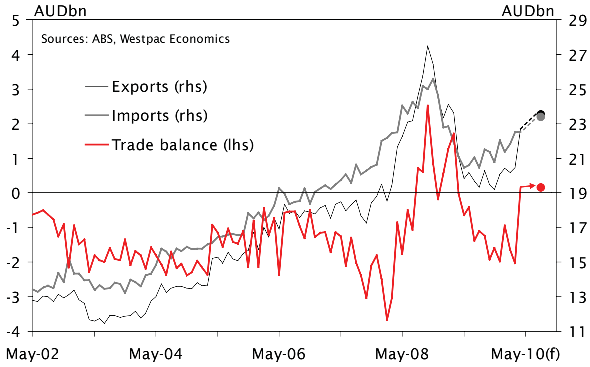


Aus May international trade balance, AUDbn

Jul 6, Last: +$0.134bn, WBC f/c: +$0.15bn – upside risk
Mkt f/c: +$0.50bn, Range: –$0.40bn to +$1.90bn

- The trade balance surged $2.174bn in Apr to a $134mn surplus as the jump in iron ore contract prices partially kicked in and coal vols surged. Exports leapt 10.7% with non-rural +18.4%. New contract prices had implied an 80% leap in iron ore export prices, but a 29% rise was reported, with the ABS noting some exporters are still trading at last year's contract prices – this implies risks of upward revisions. Early signs on Q2 export vols were positive with iron ore up 2% and coal surging 26%. Imports rose 0.1%.
- A further 7% rise in the RBA non-rural commodity price index supports May non-rural exports (led by iron ore and coal). Port data implies higher iron ore vols. But with an offsetting SAdj drag, we f/c +3% for non-rural exports. With rural exports f/c +6% (vol-led) we f/c +3.7% for total exports, with **upside risk** from greater iron ore price gains. Merchandise import data implies a 3.7% price-driven rise, with the AUD/USD down 6%mth.

Surplus w/upside: X up again on bulks' prices

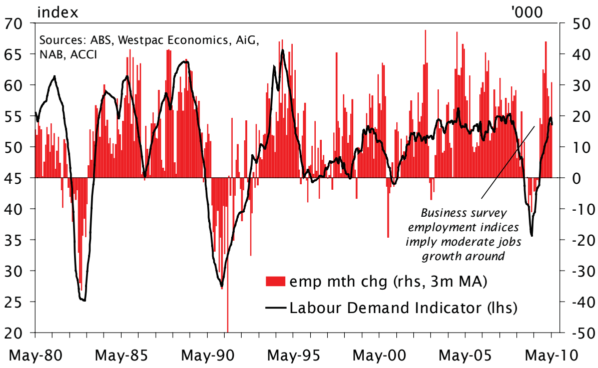


Aus Jun employment chg

Jul 8, Last: 26.9k, WBC f/c: 15k, Mkt f/c: 15k, Range: –5k to 25k

- Employment rose 26.9k in May. Monthly trend growth has eased to 18.4k from a Nov-09 peak of 35.0k, a more moderate trend as spare capacity in the existing workforce is utilised. May saw a 2.6% sa jump in average hours worked, enough to restore an uptrend. The slower monthly trend for jobs growth has still seen annual trend growth rise to 2.5% in May (highest since Apr-08) from 2.3% in April, consistent with lead indicators pointing to a rise to 3%yr in 2010H2.
- Average hours worked are trending up, but they are still 2.2% below their mid-08 peak, arguing for a continued moderate monthly uptrend in jobs. The slowing in monthly trend jobs growth has also brought the data more into line with our composite of business survey employment indices (the LDI), which in May softened to a level consistent with 17k/mth jobs. We f/c +15k jobs in June, lifting annual trend growth to 2.7%yr.

Westpac Australian Labour Demand Indicator

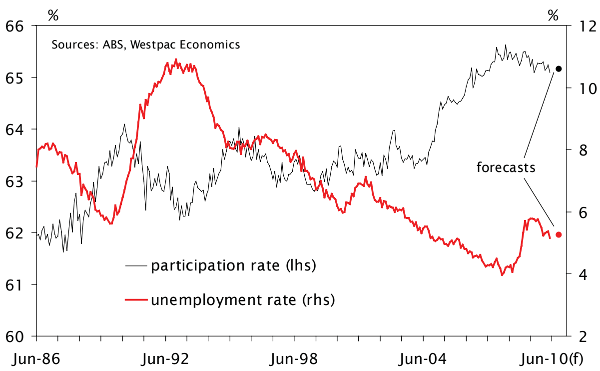


Aus Jun unemployment rate

Jul 8, Last: 5.2%, WBC f/c: 5.3%, Mkt f/c: 5.2%, Range: 5.1% to 5.4%

- The impact of the May jobs rise on the unemployment rate was boosted by a 0.2ppt fall in the participation rate to 65.1%. This saw weak labour force growth of +1.5k, allowing the 26.9k jobs rise to cut the unemployment rate 0.2ppts to 5.2%. However, the trend unemployment rate only edged down to 5.24% from 5.26%, consistent with our view that strong labour force growth over the medium term will keep the unemployment rate downtrend very gradual from here.
- Months of jobs growth around the 15k we f/c for June, especially following a month where the participation and unemployment rates have fallen around 0.2ppts, have historically seen higher labour force participation the next month. As such, we expect a 0.1ppt rebound in the participation rate to 65.2%. This lifts labour force growth, and with a softer 15k jobs gain, takes the unemployment rate back up to 5.3%.

Unemployment and participation rates

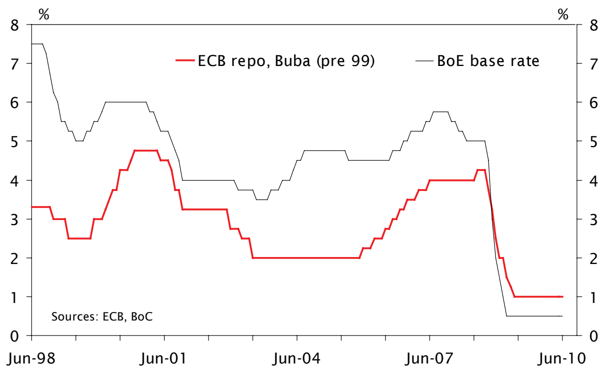


BoE and ECB firmly on hold

Jul 8, BoE: Last: 0.50%, WBC f/c: 0.50%, Mkt f/c: 0.50%
Jul 8, ECB: Last: 1.00%, WBC f/c: 1.00%, Mkt f/c: 1.00%

- Persistent headline inflation and some signs of stronger activity in 2010H1 fuelled talk that the BoE might be tempted to begin unwinding monetary stimulus before the end of this year. However the aggressive budget measures announced June 22, including sharp spending cuts, a VAT hike next year and public sector pay freeze have firmed our view that policy will remain on hold until well into 2011. That means no rate hikes or unwinding of the £200bn asset purchase program.
- The ECB is widely expected to keep policy on hold at 1.0%, with credit contracting, core inflation below 1%, fiscal policy being tightened aggressively, some major banks believed to be in difficulty and confidence in governments across southern Europe dissolving. There is still some prospect that the ECB will embark on a genuine quantitative easing program by not sterilizing its purchases of government bonds off the banks, but they will deny that until the day the start doing it.

ECB and BoE policy rates



Key Data and Events

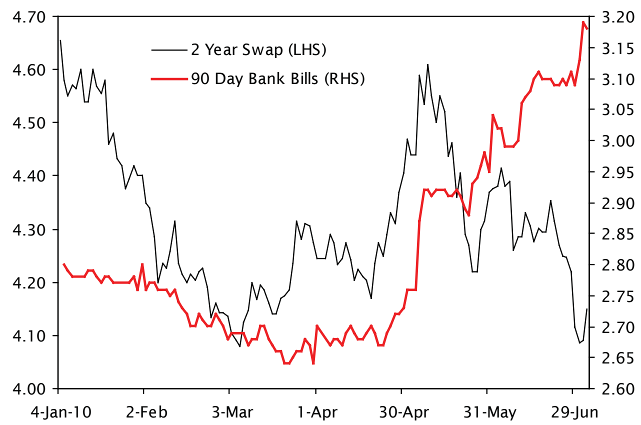
		Last	Market Median	Westpac Forecast	Comments
Mon 5 Jul					
Aus	Jun TD-MI Inflation Gauge	0.5%	–	–	Tobacco tax hike lifted May 3mth pace to 1.35% vs 1.10% in Feb.
	Jun ANZ Job Ads	4.3%	–	–	10mth uptrend has growth at 23.8%yr; implying 3%yr jobs growth H2.
US	Independence Day Holiday	–	–	–	Markets closed.
Eur	Jun PMI Services (F)	55.4a	55.4	–	Revisions usually minor but may be to downside.
	May Retail Sales	-1.5%	-0.3%	–	European household spending is in ongoing decline.
	Jul Sentix Investor Confidence	-4.1	-5.0	–	Sovereign debt, banking and global growth concerns.
UK	Jun PMI Services	55.4	55.0	–	Watch this indicator for signs budget cuts are impacting in H2 2010.
Tue 6 Jul					
NZ	Q2 NZIER Business Confidence	22%	–	–	Activity indicators holding steady, price expectations to spike.
Aus	Jul RBA Policy Decision	4.50%	4.50%	4.50%	Policy “appropriate for the near term” with mkt turmoil, pending Q2 CPI.
	May Int’l Trade Balance, AUDbn	+0.134	+0.50	+0.15	M +3.7% on AUD fall; X +3.7% (further iron ore & coal rise) – upside risk.
US	Jun ISM Non-Manufacturing	55.4	55.0	55.0	Most Jun business surveys lost some elevation.
Can	May Building Permits	5.4%	-2.0%	–	Expect housing market growth to moderate in H2 2010.
Wed 7 Jul					
US	Fedspeak	–	–	–	Kocherlakota speaking in Canada on economy, regulation.
Eur	Q1 GDP (F)	0.2%a	0.2%	0.2%	No revision expected.
Ger	May Factory Orders	2.8%	0.3%	–	Weaker euro supporting export sector.
UK	Jun BRC Shop Prices %yr	–	–	–	Guide to likely direction of CPI annual rate.
Can	Jun Ivey PMI nsa	62.7	63.5	–	Recent readings solid; possible impact from European concerns?
Thu 8 Jul					
Aus	Jun Employment chg	26.9k	15k	15k	Slower mthly trend in line with bus. surveys & spare capacity in avg hrs.
	Jun Unemployment Rate	5.2%	5.2%	5.3%	65.2% PR (+0.1), softer jobs gain lifts U 0.1, keeping downtrend gradual.
US	Initial Jobless Claims w/e 3/7	472k	460k	–	Claims downtrend appears to have stalled.
	Jun Chain Store Sales %yr	2.6%	–	–	Guide to retailing though Walmart not included.
	May Consumer Credit $bn	1.0	-2.0	-5.0	Weak May retailing suggests credit decline.
Jpn	May Machinery Orders	4.0%	-3.0%	–	Machinery sectors in TANKAN are pretty optimistic.
	May Current Account ¥bn sa	1380	1200	–	Lower income surplus, exports decelerating at the margin.
	Jun Bank Lending %yr	-2.0%	–	–	Weak demand for credit the major issue; banks are in decent shape.
Eur	ECB Rate Decision	1.00%	1.00%	1.00%	Policy firmly on hold; risk of genuine QE later in year.
Ger	May Industrial Production	0.9%	0.9%	–	Recent orders gains now driving IP higher.
UK	BoE Rate Decision	0.50%	0.50%	0.50%	Firmly on hold and QE to remain at £200bn.
	May Industrial Production	-0.4%	0.4%	–	IP is trending higher off low base.
Can	May New House Prices	0.3%	0.3%	–	Rising again for nearly a year now.
Fri 9 Jul					
NZ	Jun Electronic Card Transactions	0.2%	–	–	Total boosted by RWC tickets; retail spending more subdued.
US	May Wholesale Inventories	0.4%	0.4%	–	Further guide to extent of stockbuilding cont’n to Q2 GDP growth.
UK	May Visible Trade Balance £bn	-7.3	-7.0	–	Weakness in both X and M means little deficit change.
	Jun Producer Prices	0.1%	0.1%	–	Core output measure.
Can	Jun Employment chg	25k	15k	–	Jobs have responded to recent solid growth rebound.
	Jun Housing Starts	189k	191k	–	Some evidence coming through that housing growth is slowing.

New Zealand Economic and Financial Forecasts

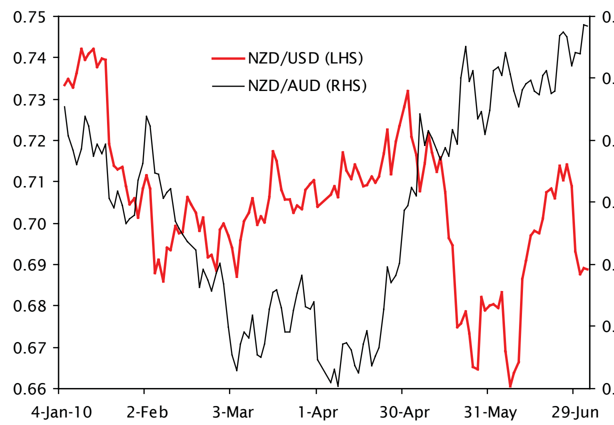
Economic Growth Forecasts	March years				Calendar years			
% change	2009	2010	2011f	2012f	2009	2010f	2011f	2012f
GDP (Production) ann avg	-1.5	-0.4	4.1	4.2	-1.6	3.4	4.4	3.4
Employment	0.7	-0.1	2.1	1.8	-2.4	2.7	1.8	1.3
Unemployment Rate % s.a.	5.1	6.0	5.3	5.0	7.1	5.5	5.0	4.9
CPI	3.0	2.0	5.1	2.7	2.0	4.9	2.6	3.1
Current Account Balance % of GDP	-7.9	-2.6	-3.3	-4.4	-2.9	-3.0	-4.4	-4.4

Financial Forecasts	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12
Cash	3.25	3.75	4.25	4.75	5.25	5.75	6.00
90 Day bill	3.70	4.20	4.70	5.20	5.70	6.10	6.20
2 Year Swap	4.80	5.20	5.50	5.90	6.20	6.40	6.50
5 Year Swap	5.70	5.90	6.10	6.30	6.50	6.60	6.70
10 Year Bond	6.00	6.10	6.20	6.30	6.30	6.40	6.50
NZD/USD	0.72	0.74	0.76	0.75	0.74	0.73	0.72
NZD/AUD	0.82	0.82	0.83	0.83	0.83	0.84	0.84
NZD/JPY	65.5	70.3	74.5	76.5	78.4	79.6	80.6
NZD/EUR	0.58	0.60	0.63	0.64	0.64	0.63	0.62
NZD/GBP	0.50	0.51	0.53	0.53	0.53	0.52	0.51
TWI	69.1	71.2	73.8	74.0	74.0	73.9	73.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 5 July 2010

Interest Rates	Current	Two Weeks Ago	One Month Ago
Cash	2.75%	2.75%	2.50%
30 Days	2.98%	2.90%	2.79%
60 Days	3.04%	3.00%	2.95%
90 Days	3.15%	3.10%	2.99%
2 Year Swap	4.15%	4.35%	4.38%
5 Year Swap	4.85%	5.09%	5.21%

NZ foreign currency midrates as at Monday 5 July 2010

Exchange Rates	Current	Two Weeks Ago	One Month Ago
NZD/USD	0.6884	0.7084	0.6690
NZD/EUR	0.5480	0.5752	0.5599
NZD/GBP	0.4531	0.4800	0.4634
NZD/JPY	60.450	64.460	61.330
NZD/AUD	0.8174	0.8076	0.8143
TWI	65.920	68.100	65.780

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2005	2006	2007	2008	2009	2010f	2011f
Australia							
Real GDP % yr	2.8	2.9	4.0	2.3	1.3	3.0	3.5
CPI inflation % annual	2.8	3.3	3.0	3.7	2.1	3.3	3.1
Unemployment %	5.1	4.8	4.4	4.2	5.6	5.1	4.8
Current Account % GDP	-5.8	-5.3	-6.3	-4.4	-4.1	-3.4	-3.0
United States							
Real GDP %yr	3.1	2.7	2.1	0.4	-2.4	2.7	2.8
Consumer Prices %yr	3.4	3.2	2.9	3.8	-0.2	1.3	2.4
Unemployment Rate %	5.1	4.6	5.8	5.8	9.3	9.7	9.9
Current Account %GDP	-6.1	-6.0	-5.3	-4.9	-2.9	-3.2	-2.4
Japan							
Real GDP %yr	1.9	2.8	2.2	-1.5	-5.8	3.3	2.0
Consumer Prices %yr	-0.3	0.2	0.1	1.4	-1.3	-1.1	-0.2
Unemployment Rate %	4.4	4.1	3.9	4.0	5.1	4.8	4.5
Current Account %GDP	3.6	3.9	4.8	3.3	2.8	4.0	4.3
Euroland							
Real GDP %yr	1.8	3.1	2.8	0.5	-4.0	0.8	1.2
Consumer Prices %yr	2.5	2.0	3.1	1.6	0.9	1.0	1.2
Unemployment Rate %	8.8	7.9	7.3	7.8	10.0	10.5	10.5
Current Account %GDP	-0.2	-0.1	0.1	-1.1	-1.0	-0.5	0.0
United Kingdom							
Real GDP %yr	2.2	2.9	2.6	0.5	-4.9	0.7	1.4
Consumer Prices %yr	2.1	3.0	2.1	3.5	2.9	2.5	2.0
Unemployment Rate %	2.8	3.0	2.5	3.1	5.0	5.0	5.0
Current Account %GDP	-2.6	-3.3	-2.7	-1.6	-2.4	-2.0	-1.5

Forecasts finalised 4 June 2010

Interest Rate Forecasts	Latest (Jul 5)	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Australia						
Cash	4.50	4.75	5.00	5.00	5.25	5.50
90 Day Bill	4.87	5.00	5.20	5.20	5.50	5.75
10 Year Bond	5.10	5.40	5.70	5.70	5.80	5.80
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.375
US 10 Year Bond	2.98	3.20	3.40	3.50	4.00	4.20
ECB Repo Rate	1.00	1.00	1.00	1.00	1.00	1.00

Exchange Rate Forecasts	Latest (Jul 5)	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
AUD/USD	0.8422	0.88	0.90	0.92	0.90	0.88
USD/JPY	87.81	92	95	98	102	105
EUR/USD	1.2562	1.22	1.22	1.18	1.18	1.16
AUD/NZD	1.2234	1.22	1.22	1.21	1.20	1.19