Economic Update

Stick to the script

10th December Monetary Policy Statement Preview

- **RBNZ to remain on hold at 2.5% and stick to the script of no hikes until the second half 2010.**
- **Economic outlook continues to improve: we expect 50bp hike in April 2010.**
- **Housing comes back to the stage: gathering momentum in house price inflation will test patience.**

The economic outlook has improved considerably over the 12 weeks following the September MPS, and even the last 6 weeks since the October OCR review. On the whole, we have seen stronger than expected developments both here and abroad which will see RBNZ reconsider the economic outlook outlined in September. Since the RBNZ last released a full set of forecasts, we have seen upward revisions to the global outlook, gathering momentum in house price inflation, stronger than expected Q2 GDP, inflation pressures unwinding slower than expected, and strength in consumer and business confidence. The export outlook is mixed, with a strong NZD remaining an issue for the sector. Fonterra's payout lift was a key upside surprise. One notable point of weakness in recent data was the disappointing employment report. However, indications from business surveys suggest that the employment outlook is improving. The main mitigating offsets to the improved outlook are tightening monetary conditions from the continued rise in the NZ dollar, combined with rising local mortgage rates. Despite the tightening monetary conditions, we think the appropriateness of an OCR at 2.5% for another 7 months must also be under consideration. We expect the RBNZ to remain on hold until April 2010, with the view the RBNZ will want to confirm and be confident growth has become sustainable before lifting the cash rate. Indications of a change in stance are a story for (possibly) the January or (more probably) the March RBNZ meetings. For now, we expect the RBNZ to toe the line of holding the current setting until the second half of 2010. When hikes do come we expect the initial ones to be aggressive (50 basis point steps) to promptly lift the cash rate off emergency settings.

Recent Developments generally positive

Plenty of positives over the past 12 weeks.

Dairy prices lift.

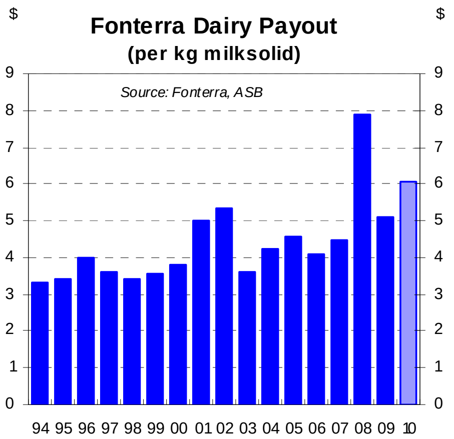
A key upside surprise for the export sector came in November when Fonterra raised the payout forecast for the 2009/10 season to $6.05 (+95c) per kg of milk solid. While spot dairy prices had been increasing in recent months, the $6.05 payout was higher than most market expectations. A higher payout provides a shot in the arm to dairy farmers, and alleviates some concern about a high level of agricultural debt.

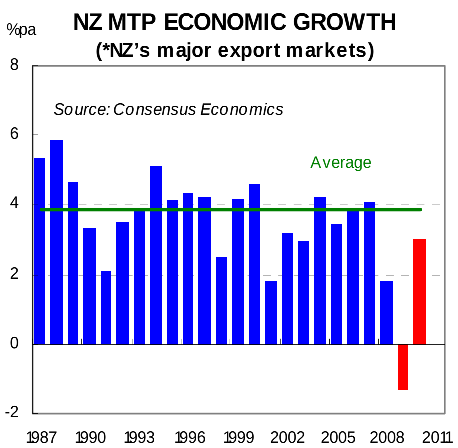
Global growth prospects improve.

Since June *Consensus Forecasts* have shown the expectation for economic contraction for 2009 has steadily been revised to a milder one, and the growth forecast for 2010 has been steadily revised up for New Zealand's major trading partners.

Mixed export outlook.

The improving prospects in key export markets have in part been offset by a stronger NZD. The NZD TWI has risen 25% since the early 2009 lows and is around 2% stronger than the RBNZ's September forecast. Importantly, we expect the TWI to keep rising, in contrast to the RBNZ's expectation for it to peak in the current quarter. The export sector outlook is mixed. The recovery in global dairy prices has more than offset the strong NZD. In contrast, lamb and beef prices are down on year-ago levels in NZD terms.





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The tourism outlook is also mixed. Strong visitor numbers from Australia are a help, but a recovery in arrivals from big-spending countries such as Japan, North America and Europe is needed to boost the sector and that will take time.

Confidence remains strong.

Consumer and business confidence have remained at relatively high levels over the past few months. Retail trade over the third quarter was a touch stronger than expected, but consumers continue to appear far more restrained than a few years ago, which should comfort the RBNZ. There have been only tentative signs of a flow-through of strong business confidence to real activity in recent months, but improvement in firms' own activity expectations points to ongoing recovery in economic activity.

Unemployment higher than expected.

One notable point of weakness in recent data was the higher than expected unemployment rate posted in Q3. However, employment and investment intentions have improved in recent business surveys, suggesting a turnaround should come for the labour market in H1 2010. Another point of relative weakness is credit growth. Mortgage lending growth is slowly picking up, with annual growth having bottomed out at 2.8%. Despite improving intentions to invest, business credit continues to shrink on an annual basis, and agricultural lending growth is decelerating. The latest figures suggest the RBNZ will remain comfortable for now that a credit-fuelled lift in domestic demand is not imminent.

Q3 inflation stronger than expected.

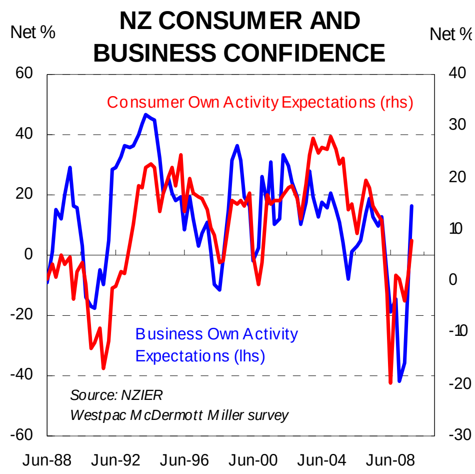
Headline inflation in Q3 was significantly stronger than expected. The RBNZ was expecting annual inflation of 1.2% – instead the headline printed at 1.7%. As far as surprises go for inflation that's about as big as they get. Despite the recession, domestic inflation is proving very stubborn to unwind. As the local recovery has progressed, the downside risks to the inflation outlook have diminished rapidly.

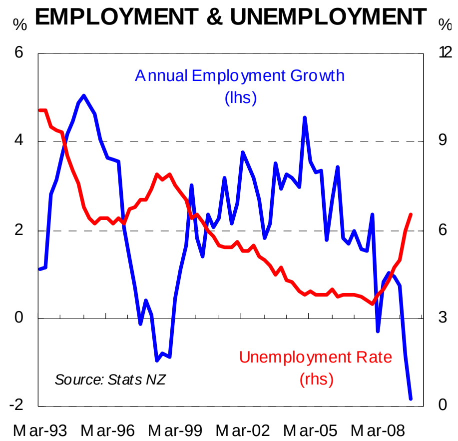
Housing market remains tight

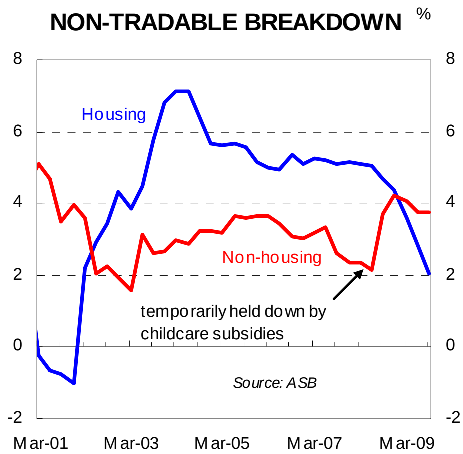
Since the September MPS, the housing market has continued to improve. House prices are now rising sharply. Tightness in the housing market has intensified as supply levels have been slow to respond to the lift in demand for housing. One factor behind the demand is an increase in net migration. Population growth from positive net migration increases the housing requirements for NZ. The supply-constrained nature of house prices is unlikely to persist. We expect the rise in house prices will attract more sellers onto the market and encourage new housing construction, which in time will restore the balance between supply and demand. Nonetheless, the turnaround has been sharp, with house prices having already lifted strongly off its lows. The REINZ stratified median has surged from $340,000 trough to $370,000 in a matter of months and are now only $10,000 below the 2007 peak. A continued surge in house prices will certainly test the RBNZ's patience.

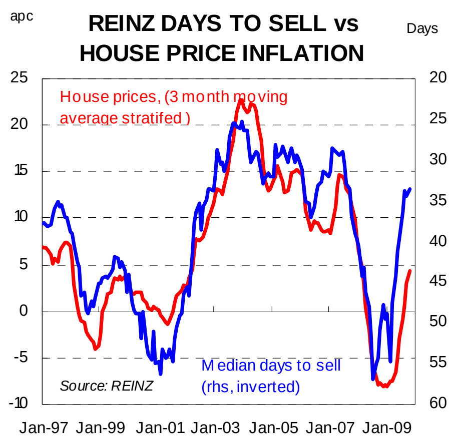
Pushing prices up at an uncomfortable pace…

… testing RBNZ patience







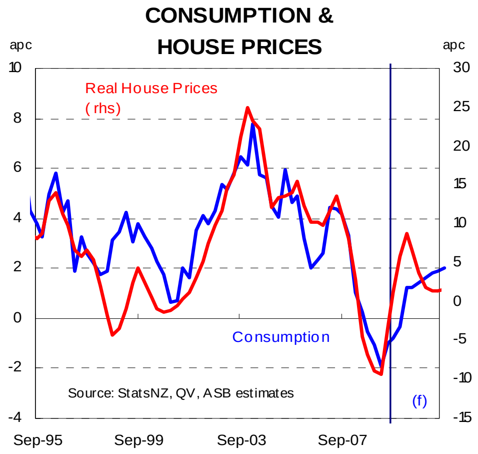


Housing headache for the RBNZ

Housing a duel threat for the RBNZ.

The strength of recovery in house prices is a threat to the RBNZ for two reasons. Firstly, the strength in house prices has inflationary consequences and could once again stimulate consumption via the wealth effect. Secondly, a return to borrowing excessively against housing would undermine the much needed rebalancing of the economy the RBNZ continues to push for. There are both direct inflation consequences (and potentially rents also) and indirect consequences from stronger house prices. As house prices close the gap from their recent peak the wealth effect on consumption may once again resume. As consumer confidence lifts and equity in household balance sheets recovers, households will feel less pressure to save a greater portion of their income. More directly, the demand for housing and constrained supply will eventually stimulate more construction. As this sector recovers, its current disinflationary influence will abate.

Back to the borrowing and spending ways?



Macro stability is an ongoing concern.

But macro-stability is increasingly an issue for the RBNZ. New Zealanders are once more willing to borrow money to bid up house prices that are already at stretched levels. The fundamentals on house prices are already stretched: house prices and debt levels are elevated relative to incomes.

A recovery in appetite for housing credit undermines the improvement in the saving rate and risks exacerbating New Zealand's external indebtedness. NZ has a limited pool of domestic savings to call upon to fund credit growth. Growth in housing debt will either be funded from offshore or come at the expense of credit to other sectors. The RBNZ would see neither option as ideal. Should current momentum continue in housing demand, the RBNZ may be forced to act on recent rhetoric. That is, to increase the OCR to cool housing demand to ensure the medium-term sustainability of growth as well as respond to looming inflation risks.

Taxing issues

Is it time to change tax rules on housing?

The RBNZ recently hinted in its Financial Stability Report that there is a role for fiscal policy to remove the tax distortions which currently favour housing demand. Given the current tax review, there has been speculation that the Government may indeed step up and introduce some sort of tax change to influence the property market, which would have the potential to be very helpful for the RBNZ. However, in order to stave off an April OCR hike any changes would need to be done very soon (i.e. an announcement in the December 15th Half Year Economic and Fiscal Update). In addition, the new policy would need to cause an immediate effect on the housing market. If the RBNZ is still seeing strong demand in the housing market continuing through to March it might find its patience has worn out. Recent rhetoric from the government suggests any policy changes are unlikely to occur soon enough.

Sticking to the script for the RBNZ

RBNZ to monitor household-led recovery…

The RBNZ is likely to retain a similar tone to the October statement in reiterating the OCR will be on hold until the second half of 2010. Concerns regarding the sustainability of the recovery still exist, even as the housing market continues to show strength. Upcoming data on the household sector will be pivotal to how long the RBNZ is willing to wait before it raises the OCR.

…while sticking to 2010H2 guns

While confidence amongst consumers and businesses has been high in recent months, the flow-through to real activity has been muted so far. Consumer credit is still contracting and household spending is only showing tentative signs of picking up. Furthermore, business credit and capital investment remain weak. Households and businesses may be feeling better generally, but at the moment it is only cautious optimism and there is an apparent reluctance to act on it. Similarly, the RBNZ is likely to adopt a wait-and-see approach and look for more certain signs that a recovery is underway before it removes monetary policy stimulus. As such, for now it will continue to indicate the second half of 2010 as the appropriate timeframe to start removing stimulus.

Markets have currently priced in a 25 basis point OCR increase for April and another one by June. From a strategic point of view, the RBNZ will want to continue dampening down expectations that a rate increase will be occurring earlier, in order to encourage households to move onto floating interest rates over the coming months. A greater proportion of households on floating interest rates will mean a greater effect when the tightening cycle does begin. Whether the RBNZ can afford to wait until the second half of 2010 will become clearer over the coming months.

Implications

Sticking to the message for now…

We expect the RBNZ to continue with its deliberately dovish tone in both the December and January announcements. In October the RBNZ was very direct in its comments about market pricing. The message was effective as markets have since backed off expectations of an earlier rate hike, a result the RBNZ will be pleased with. Over the next couple of meetings the RBNZ are likely to stick to a similar script to avoid pricing getting too far ahead of what the RBNZ deems as appropriate.

..but eventually a sharp change in tune

But the longer the RBNZ sticks to that script in a generally-improving environment, the more rapid the eventual shift in stance is likely to be. Over time the inflation outlook will start to look less benign and continued recovery in house prices will take on more importance. By March, patience with the housing market will likely wear thin, and we expect cracks in the RBNZ's façade to appear. By April the RBNZ is likely to find itself in a position where it will need to slow the housing market via a higher OCR to prevent further aggravation of New Zealand's imbalances and vulnerabilities (not to mention anticipation of inflation). But right now, even though market pricing is behind – rather than ahead – of our OCR outlook, the RBNZ is unlikely to prompt more aggressive pricing of OCR hikes.

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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