ECONOMICS

3 Sep. 09

Economic Update

To cut or not to cut?

Preview of September 10th Monetary Policy Statement

- **Monetary conditions have tightened since July, testing the RBNZ's strong easing bias.**
- **We expect RBNZ to cut the OCR 25bp, to anchor expectations and offset the impact of the NZD.**
- **However, the market expects 'green shoots' optimism to keep the RBNZ on hold at 2.5%.**

It is crunch time for the RBNZ's attempts to influence monetary conditions. In July the Bank stated that continued tightness in monetary conditions could lead to a reassessment of its policy stance. Since July, conditions have tightened further, with both the NZ dollar and longer-term interest rates drifting higher. If the RBNZ is still concerned about tight monetary conditions it now has to decide whether it will follow through on its implied threat and cut, or whether it resigns itself to the role of spectator. A related issue is that the RBNZ's assumption that the NZD will drop and sustain a low level is increasingly shaky and needs to be reassessed. We are tipping our hat to a 25bp cut on September 10, but we freely acknowledge that we are in a distinct minority in suggesting the RBNZ will cut. Market pricing implies only a 10% chance of a cut. At the very least, the RBNZ is likely to try and reinforce that OCR increases are a lot further off than the market is pricing in. However, without action to accompany this stance, continued jawboning will fall on deaf ears.

Stabilising outlook may bring end to the easing cycle

Reasons to remain on hold

With the economic outlook stabilising and green shoots continuing to sprout up, the downside risks are diminishing and the RBNZ may simply keep the OCR at 2.5%. Some reasons to remain on hold are:

Global growth forecasts revised up

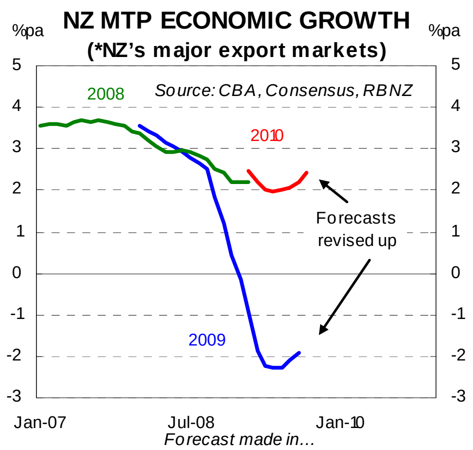
- The global economy is stabilising. Over recent months, forecasts for global growth have been revised up, led by Australia averting recession and a strong bounce back in Chinese economic activity. *Consensus* forecasts now imply a slightly better global outlook than the forecasts incorporated in the June MPS.
- Fonterra's on line dairy auction has shown encouraging signs that prices are recovering.

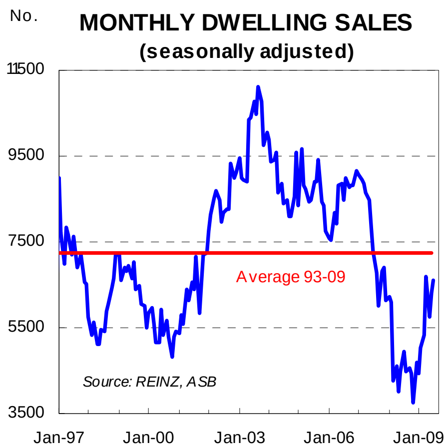
Confidence improving

- Business confidence has recovered substantially.

Housing-led recovery underway

- The housing market has lifted markedly off its lows and the increased level of demand is likely to remain underpinned by the pick up in net migration.
- Retail spending data suggest consumer spending growth is already recovering and in our view won't be as weak over the next few years as the RBNZ has assumed.
- The RBNZ may be reluctant to cut the OCR further, if only to reduce the risk of fuelling the household-led recovery which could slow the correction in NZ's external indebtedness.





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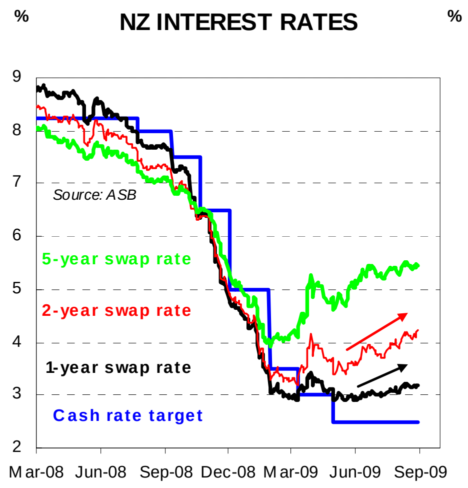
Reasons to cut

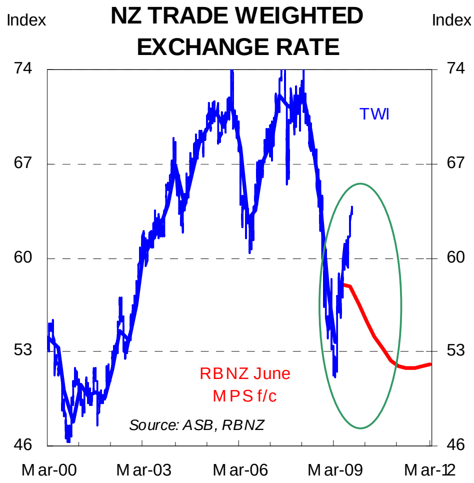
Monetary conditions have already tightened

Monetary conditions have tightened further since July and the risks to the inflation outlook remain strongly to the downside. The RBNZ needs to be wary that doing nothing will risk killing off the recovery when it remains fragile. Various arguments for cutting are:



NZ interest rates pulled up by optimistic Aussie

- NZ monetary conditions are being dragged higher as global prospects improve, particularly as expectations for higher Australian interest rates get brought forward. New Zealand is experiencing a defacto tightening because of Australia's better economic outlook. An OCR cut would be a very clear-cut way of differentiating NZ's more precarious economic recovery from Australia's relatively robust performance.



Longer-term interest rates no longer stimulatory

- Long-term mortgage rates are back to, or above, long-term averages. It is really only rates out to 2 years that are outstandingly cheap and can be thought of as stimulatory. Even then, these shorter rates have started to lift more recently as markets bet on the RBNZ tightening much sooner than the RBNZ implies it will.

High NZD thwarting economic recovery

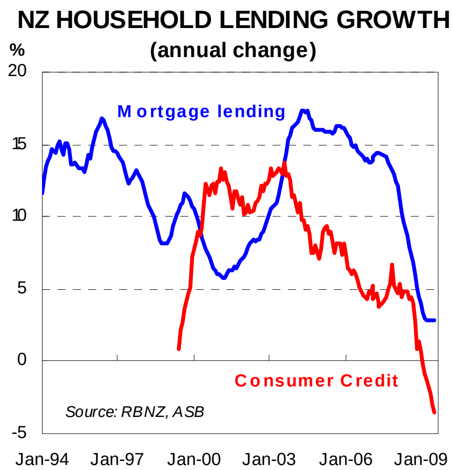
- The higher NZD is also contributing to tighter monetary conditions. The RBNZ has assumed for the past 6 months that the NZD will fall to a very low level and remain weak for several years. However, it has become increasingly clear that this may not be the case. The primary reason the RBNZ expected the fall was based on NZ's huge external financial liabilities. However, if those liabilities didn't cause the NZD to fall when the crisis was still fresh, why would they when the crisis is steadily on the mend?
- The impact on exports has yet to be fully felt, in particular the strength in the NZ dollar will make any export-led recovery very difficult. The positive news from the dairy auction is primarily that there is less risk of Fonterra cutting the 2009/10 payout from $4.55. Even then, there is going to be a lot of belt-tightening in dairying regions. Tourism is under pressure outside ski tourism, and will remain under the gun.

Housing recovery fragile

- Yes, the housing market is recovering. But the recovery to date is still weak. Sales turnover has lifted sharply, but the increase has lost some momentum since April and mortgage rates have now started to rise. Mortgagee sales numbers continue to rise. There is low risk that another OCR cut will trigger a huge mortgage lending boom.

Credit growth remains very weak

- Credit growth remains weak and symptomatic of a struggling economy. Mortgage lending data published by the RBNZ is running below an annual pace of 3%, by far the weakest pace on record. Consumer lending also shows little sign of recovering, having shrunk nearly 4% over the past year. Business credit demand is weak.



Inflation pressures still too weak

- Inflation is likely to bounce around the bottom of the target band over the next two years, meaning the risks are skewed to uncomfortably low inflation. Wage growth has weakened earlier than the RBNZ has assumed.

Liquidity policy to put pressure on lending rates

- The RBNZ's new liquidity policy will encourage banks to concentrate on funding via the more expensive but more stable sources: retail deposits and long-term funding. All else equal, this will put further upward pressure on lending rates.
- Phasing out of the retail deposit guarantee scheme will further constrain credit provided by the non-bank sector, particularly consumer credit.

Two paths for the RBNZ

RBNZs easing bias to be tested

It is possible the RBNZ concludes the economy is happily on the mend and believes the tightening underway (via the NZ dollar and long-term interest rates) is warranted. However, such an outcome seems unlikely given Dr Bollard's still-cautious comments over the past week.

We expect the RBNZ still views the tightening in monetary conditions as undesirable. In July's OCR review the RBNZ said its forecast recovery was "based on a further easing in financial conditions" and could be at risk without that easing. Developments since then have been positive, but not enough to make up for the huge gulf between current monetary conditions and the RBNZ's outlook for them. At some stage the RBNZ is going to have to build in a substantially higher NZ dollar into its economic outlook than it has to date.

The RBNZ has two main choices:

- Reiterate that monetary conditions will remain tighter than desirable but resign itself to the role of spectator, or
- At least try to influence monetary conditions, following through on July's stronger easing bias.

The issue is how much resolve does the RBNZ have to act? Both of the above strategies have some risks.

Keeping the markets expectations anchored more difficult

The on-hold scenario will presumably be accompanied by similar comments to the past two statements, implying the RBNZ will not lift rates for a considerable period. Continuing to make these comments will do little to change market perceptions. The market is pricing in little chance of a further cut and lack of follow-through on July's veiled threat to cut can only reinforce that the rate outlook is a one-way bet.

The risk with cutting is that it may not have any lasting effect. But if the RBNZ is genuinely worried about overly tight monetary conditions it should act rather than hold back for any fears of being perceived as ineffective.

Forecasting reality

RBNZs June NZD assumption needs to be revised…

At some point the RBNZ is going to have to face up to the NZD remaining stronger for much longer than it has assumed, with consequent implications for the economic recovery it has been forecasting – including a weaker inflation outlook. The RBNZ has been forecasting the nirvana of an economy rebalancing away from consumption to exporting. But to quote Mick Jagger, one-time student at the London School of Economics, you can't always get what you want. The initial stage of the recovery is inevitably going to be household led: households fell into a huge hole before other sectors, while challenging times for exporters are a more recent development.

…also needs to accept housing led recovery

The RBNZ's forecasts need to shift to reflect slightly stronger consumer expenditure but a much weaker export outlook. The overall impact would likely be slightly slower forecast economic growth over the medium term and – critically – a weaker inflation outlook.

Implications: player or spectator?

We are tipping our hat to a 25bp cut on September 10, but we freely acknowledge that we are in a distinct minority in suggesting the RBNZ will cut. Market pricing implies only a 10% chance of a cut.

Call for cut in the minority

We judge the RBNZ is still worried about economic recovery being hampered by overly tight monetary conditions. Nevertheless, in the current 'green shoots' environment staying on hold is the easy decision to make. Cutting the OCR is a more courageous course, but for the sake of those businesses still feeling pressure it just might be worth a crack.

But RBNZ needs action to convince the markets

We see little room for regret in the RBNZ cutting the OCR. Trying to talk the NZD and interest rates down has had no lasting effect, and inaction risks further undermining the RBNZ's attempts to try and condition rate hike expectations. The market is calling the RBNZ's bluff: if the RBNZ folds the market will continue to up the ante on rate hikes. In contrast, if the RBNZ cut the OCR but found down the track the economy and inflation were picking up quicker than expected, it will have little difficulty letting tighter monetary conditions off the leash.

So the wildcard for the September 10 is an OCR cut – though don't bet the house on it! A rate cut at a time when (virtually) no-one is expecting it would have a high chance of triggering lower wholesale rates and a drop in the NZD for a while. At the least, the RBNZ is likely to try and reinforce that OCR increases are a lot further off than the market is pricing in.

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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