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RODNEY'S RAVINGS

A lower OCR need not mean a lower NZD

EXECUTIVE SUMMARY

There has been another call for the Reserve Bank (RBNZ) to cut the OCR in an effort to get the NZD down and help the traded-goods sector (i.e. improve the international competitiveness of exporters and local producers competing against imports). This Raving explains why cutting the OCR in the current environment is more likely to result in a higher rather than lower NZD. The experience in 1993 provides a useful case study for why lower interest rates can result in a higher NZD. However, if the swine flu has a sufficiently large negative economic impact it results in further OCR cuts this is a different matter and may or may not result in a lower NZD.

Unfortunately most views on NZD prospects are not founded on an understanding of what actually drives the exchange rate. By contrast through various Ravings and via our monthly **Forex Prospects** reports we offer unique insights into what actually drives the exchange rate and exchange rate prospects.

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Will a lower OCR result in a lower NZD?

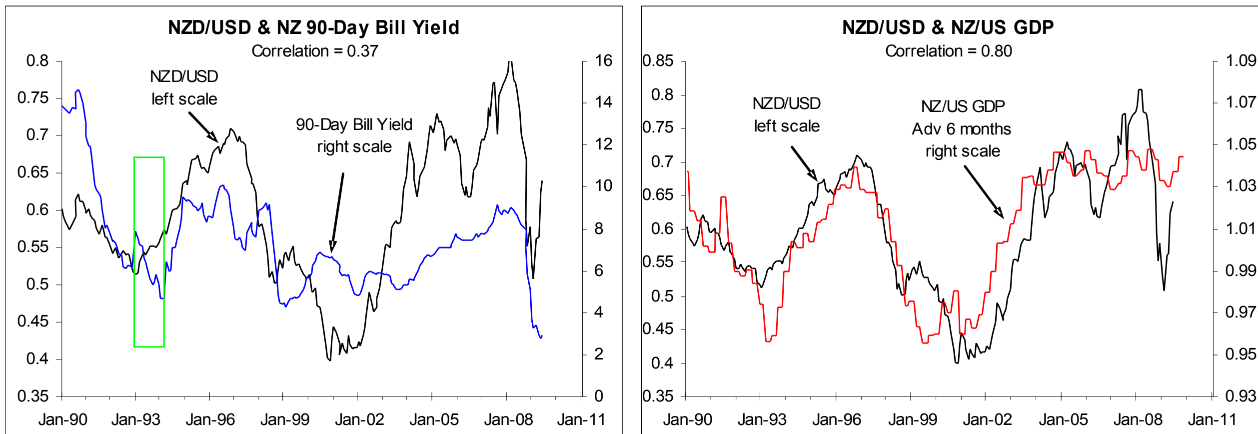
As reported by Business Day on 19 June 2009:

"Another cut to the Official Cash Rate (OCR) would be a more effective way for the Reserve Bank to weaken the Kiwi dollar rather than its governor "jawboning with a feather", says TD Securities senior strategist Annette Beacher." (Source: http://www.stuff.co.nz/business/market-data/2517459/Bollard-jawboning-with-a-feather)

The line of reasoning seems to be that lower interest rates will discourage international investors and result in a lower NZD which will improve the international competitiveness of the traded-goods sector (i.e. exporters and local firms competing against imports). This is a worthy cause and fits with the desire by the RBNZ to "rebalance" the economy (i.e. aid the competitiveness of the traded-goods sector and encourage consumers to save more and spend/import less). But wishful thinking isn't a good basis for policy recommendations!

In a recent Raving I explained the pitfalls in the consensus view of NZD prospects, with suggestions that a lower OCR will result in a lower NZD fitting with the misguided consensus view of what drives the NZD (see http://www.sra.co.nz/pdf/NZDrevisited.pdf). In previous Ravings I have explained what drives the cycles in NZD (see http://www.sra.co.nz/pdf/NZDUSD.pdf and http://www.sra.co.nz/pdf/NZdollarRaving.pdf). But it seems that the conventional view that lower interest rates will result in a lower NZD persist because too often views on the exchange rate are based on wishful thinking and/or ill-informed views. From my observation most people commenting on exchange rate prospects, including often economists and strategists, do so without having researched properly what actually drives it.

A look at the relationship between the NZD/USD and NZ short-term interest rates on the one hand (the left chart) and the relationship between the NZD/USD and relative NZ-US economic activity on the other hand (the right chart) provides the insight needed to debunk the view that a lower OCR will necessarily result in a lower exchange rate. The OCR only came into existence in March 1999 so to look at the relationship between the NZD/USD and interest rates the left chart uses the 90-day bank bill yield because it is the benchmark short-term wholesale interest rates and is largely driven by what the RBNZ does with the OCR.



The left chart shows a poor relationship between the NZD/USD and the 90-day bank bill yield. There are a number of periods that the NZD/USD and the 90-day bank bill yield move in opposite directions while the poor overall relationship is reflected in the low correlation of 0.37. A correlation of 1.0 reflects a perfect fit so a correlation of 0.37 is closer to a zero reading than a perfect fit.

Case studies can be helpful in understanding how markets work and in this instance the experience in 1993 when the NZ economy was emerging from a deep and protracted recession is relevant (see the green box in the left chart). The NZD/USD (and the NZD TWI) started rising in 1993, reflecting the forex market's view that the NZ economy was on the mend, but the RBNZ was slow to recognise that a recovery was underway and in response drove short-term interest rates down. Of course the lower interest rates resulted in a stronger upturn in the domestic economy and most notably in the housing market, which the forex market responded to by pushing the NZD higher not lower. In terms of the NZD/USD the forex market responds most to NZ-US relative economic activity as shown in the right chart - note the high correlation of 0.8.

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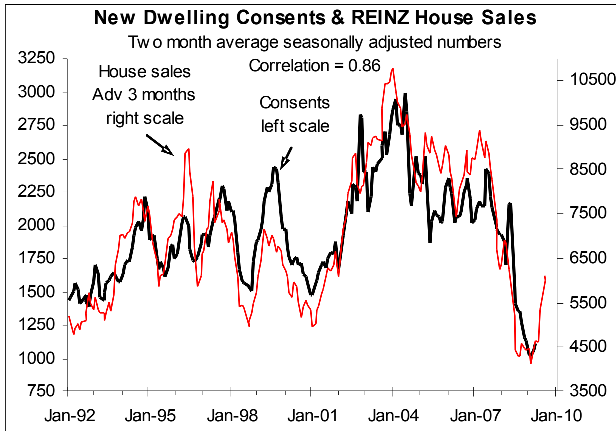
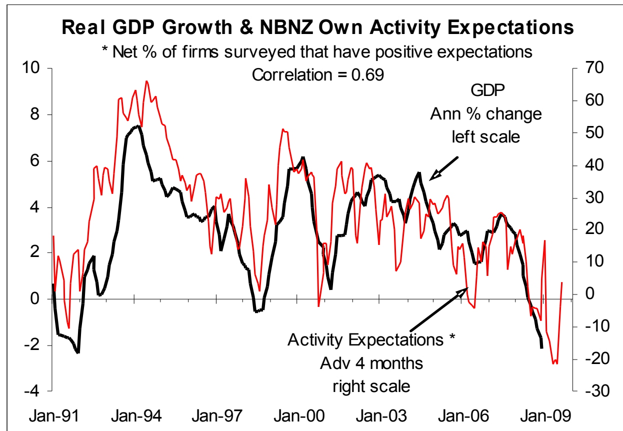
The general rule is that if you cut the OCR/short-term interest rates when the economy is already recovering the forex market will take the NZD higher not lower, while the lower interest rates will fuel a stronger upturn in the domestic economy (i.e. OCR cuts in the current environment would exacerbate the "rebalancing" of the economy rather than aid it). The earlier Ravings explain why the NZD/USD is highly correlated with relative NZ-US economic activity including covering the all important issue of why currency investors and traders respond to relative economic activity much more than to either local interest rates or relative NZ-US interest rates.

In the Business Day article it stated that ""TD Securities did not expect economic fundamentals to justify sustained New Zealand dollar appreciation until next year." This is much like the RBNZ being slow to recognise that an economic recovery was unfolding in 1993 and reinforces my observation that the forex market is generally quicker than both the RBNZ and economists to pick when economic recoveries (and recessions) are unfolding. The economists again are doing what they are best at, which during economic recoveries is finding reasons why it won't happen yet (although the swine flu may complicate things if it tempers or delays the recovery). The left chart shows the increase in the number of REINZ house sales as a leading indicator of the number of consents for new dwellings (i.e. as covered in our monthly **Building Barometer** reports the recovery in residential building will start well before the economists are predicting - see http://www.sra.co.nz/building.html for information on these reports). The right chart shows the NBNZ survey of firms' own activity expectations as a leading indicator of annual GDP/economic growth, with this survey returning to mildly positive territory in May and suggesting that positive economic growth should return before the end of the year.





The best read available for anyone wanting to understand what actually drives economic recoveries is the last Raving, titled "***Consumer spending growth will recover earlier than is generally expected***" (see http://www.sra.co.nz/pdf/Consumer.pdf). While our views on economic growth prospects are updated in the monthly **Interesting Times** reports (see http://www.sra.co.nz/interesting.html for info on these reports).

In the context of NZ's unfolding economic recovery the forex market is behaving normally (i.e. pushing the NZD higher and baffling most commentators and the RBNZ). But this time around it is as much about the unfolding recoveries in the international financial markets and in the global economy, as is covered in our monthly **Forex Prospects** reports that are a must have for anyone serious about understanding what actual drives the exchange rate and having the best available insights into exchange rate prospects (see http://www.sra.co.nz/currencyservices.html for information about the **Forex Prospects** reports or contact me).

When viewed in the context of the economic fundamentals the forex market focuses on, the fall in the NZD last year was larger than justified. The NZD tumbled as much as it did because risk aversion dominated proceedings. Investors/traders retreated from NZ, a small country with a large external deficit but without a major banking sector crisis, in favour of the US that was at the epicentre of the financial crisis. This is reflected by the NZD/USD falling more than justified by relative NZ-US economic activity in the right chart on the previous page. So as covered in recent **Forex Prospects** reports, it was always likely that the NZD/USD (and the NZD TWI) would surprise most people by rebounding once the financial crisis started to heal and the global and local economies started to recover.

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