

Economic Review

New Zealand

11 June 2009

RBNZ June Monetary Policy Statement Review

Key points

- > The RBNZ leaves the OCR unchanged at 2.50 percent as we had expected.
- > While acknowledging signs of stabilisation and noting some upsides from migration and a housing recovery, the RBNZ still see risks to the downside on balance.
- > In the Bank's view, any recovery is likely to be "slow and fragile" – a sentiment we share.
- > The lower for longer message is being rammed home, with the RBNZ emphasising that "it is likely to be some time before the recovery becomes self-sustaining and monetary policy support can be withdrawn."
- > While the RBNZ has left the door open for further cuts, they appear comfortable at present. Absent of a further material deterioration in economic prospects or a rise in systemic risks to the financial system, we believe this easing cycle is now over. But hikes are still some way away.

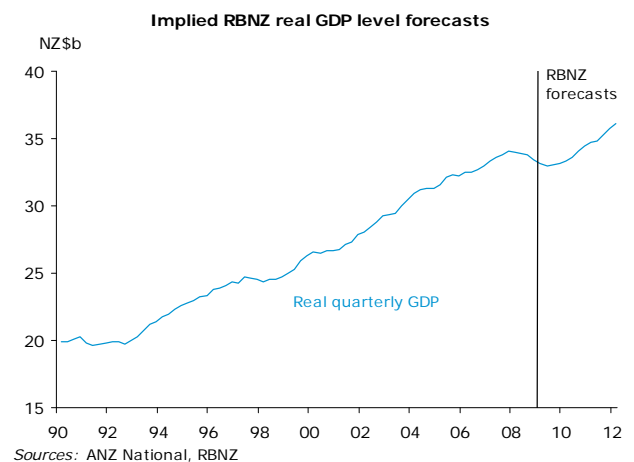
Assessment

While the OCR was left unchanged at 2.50 percent this morning, the RBNZ still delivered a very circumspect statement. With comments such as "unhelpful tensions" in regards to the rise in the NZ dollar, "below the bottom of the target band" for near-term inflation, and "risks to activity remain weighted to the downside" in describing the economic outlook, it is clear that the spirit of what the RBNZ is trying to achieve is to reinforce the message that they have delivered previously: this recovery and rebalancing in the economy is going to take some time to play out and we are facing a very "U" or bathtub shaped adjustment.

While the Bank highlighted some of the positives emerging around the globe and the expectation of the NZ economy returning to forward momentum later this year, their view on the recovery is clear – it is "likely to be slow and fragile." There was significant emphasis on the risks remaining to the downside, though the RBNZ noted some clear upsides as well from net migration and a rebound in the housing market. **Migration is now an important focal point to watch.**

Interestingly, the RBNZ do not expect the recent momentum in household spending and the housing market to be sustained given the outlook for employment, farm incomes and high household debt. This is a view we concur with. While the RBNZ's GDP growth forecasts have the economy rebounding towards 4 percent growth by the end of 2011 – and it looks like a "V" shaped cycle – this is largely a function of coming from a deeper trough. In level terms, real economic activity does not recover to pre-recession levels

until the end of 2010 and this is more consistent with the bathtub or saucer shaped cycle. Given the economic outlook, inflation is not a major concern, and the RBNZ is confident that inflation will remain within the target band throughout the projection period (with a temporary dip below the band).

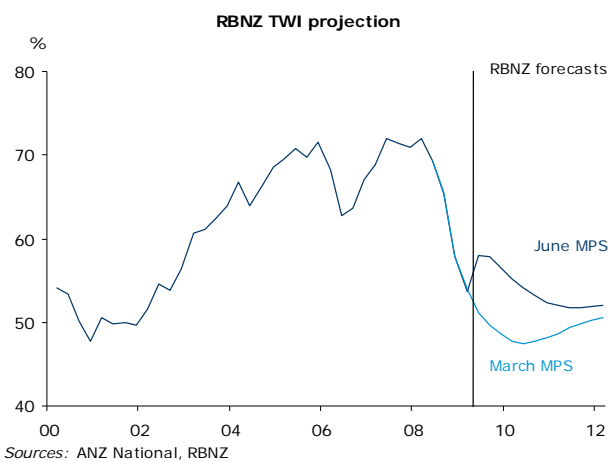


In terms of the core economic projections, the RBNZ sees the unemployment rate rising past 7 percent, business investment to stay subdued, and household spending to consolidate, leading to a rise in the savings rate. These are broad themes we concur with. The initial subdued recovery in the economy is primarily driven by government spending, with private sector activity only starting to pick up late next year.

The question then is how come the RBNZ did not cut the OCR further given their circumspect and cautious outlook? There are three main reasons for this. Firstly, the RBNZ has already eased aggressively by 575bps since July

last year. Some of this easing was front-loaded in anticipation of the negative effects of the global economy on NZ. While the NZ economy will still feel the effects of the global recession, recent indicators point to stabilisation, as opposed to a further deterioration, in prospects offshore. Secondly, past easings are still to flow through the economy, and the RBNZ is banking on more households and businesses getting the benefit of lower interest rates as they roll off existing fixed rate terms. Thirdly, part of the rationale for taking an aggressive policy stance early was to minimise systemic risks in the domestic financial system, at a time when there was tremendous fragility in the global system. With offshore credit markets thawing and a large part of the systemic risks removed, there is less onus on the RBNZ to do more and react to financial aspects to the global downturn. Indeed, the RBNZ note that growing evidence of stabilisation is turning their attention naturally towards recovery.

The RBNZ are wary about the recent rise in the NZ dollar, noting that *"A stronger dollar at a time of weak global growth risks delaying or even reversing the projected increase in exports, putting the sustainability of recovery at risk"* – a point we agree with. This comment is similar to those made by the Bank of Canada last week.

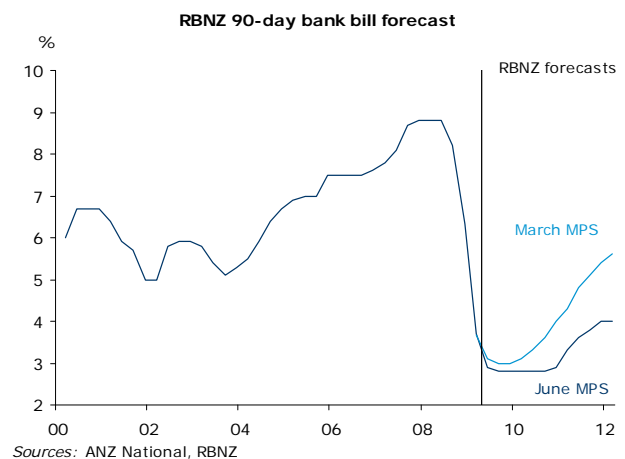


Indeed, in the *Monetary Policy Statement*, the RBNZ portrayed an alternative scenario where the currency remained higher for longer and household spending rebounds more strongly, leading to an increase in imbalances. This scenario would ultimately lead to a smaller economy and lower living standards over the medium-term – a clear message that the RBNZ views recent NZD appreciation as unhelpful and would like to see it adjust lower. The upside currency scenario has no clear interest rate assessment but clearly highlights that a stronger currency will merely widen imbalances and lead to a deeper adjustment down the track. Hence, it looks to be a simple question of timing in terms of when the currency adjusts. Ironically, the path to a lower currency looks to be

built around crushing the economy and then having the currency needing to adjust lower.

Overall, while the RBNZ sees scope for further modest reductions in the OCR over coming quarters, it seems the Bank is fairly comfortable with policy where it is. This is easy to rationalise given dissipating systemic risks, although clearly the NZ economy faces challenges ahead. But with the OCR at 2.5 percent, the RBNZ has already responded aggressively to both economic and financial aspects to the cycle.

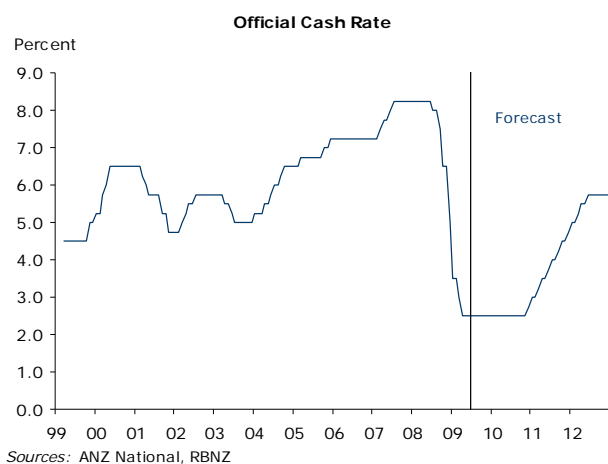
The RBNZ reiterated the comments from April that they expect to keep the OCR low through to the latter part of 2010. The RBNZ also reinforced this message by stating that *"it is likely to be some time before the recovery becomes self-sustaining and monetary policy support can be withdrawn"*, and presenting a 90-day track that stays flatter for longer relative to their March projections. The June 90-day projections have it staying at 2.8 percent until the end of 2010 before rising modestly to 4 percent by the end of 2011. The spirit is clear: rates are set to remain low for an extended period, in effect ramming home the message they have delivered previously.



Implications

While the RBNZ has left the door open for further cuts, lacking an offshore trigger, 2.5 percent looks to be the trough in the policy cycle. Absent a further material deterioration in economic prospects or a rise in systemic risks to the financial system, we believe this easing cycle is now over. This is despite the considerable wariness we have towards the NZ economy. However, facing a structural rebalancing process, there is simply some aspects to the economic cycle that policy cannot and should not respond to. Looking towards the potential normalisation in policy, we have pencilled in the start of the tightening cycle in late 2010, concurring with the elongated economic adjustment prognosis.





There is an inevitability about what needs to happen for the NZ economy to rebalance, and it includes a weaker currency. However, the issue is really one of timing. The longer the adjustment is pushed out (via rejuvenated domestic demand, especially the housing market, and a stronger currency), the higher the potential for a more severe correction on the other side.

We are siding with the RBNZ in viewing that recent tensions (and a rising currency) will not last long. However, for now, the market has taken the decision as NZD positive, gaining over 70pips against the USD and almost 100pips against the AUD. A lot of this looks to be position related and we expect global forces to dominate once again overnight. Swap yields sold off across the curve. While on the face of it this appears to be some cynicism towards the “lower for longer” message as yet, this looks to be more flow and expected mortgage related pay-side pressure.

RBNZ Projections for June MPS (March 2009 MPS Projections in brackets)					
Half year average	H2 2009	H1 2010	H2 2010	H1 2011	H2 2011
90 day	2.8 (3.0)	2.8 (3.2)	2.9 (3.8)	3.5 (4.6)	3.9 (5.3)
TWI	57.1 (49.2)	54.7 (47.5)	52.8 (47.9)	51.9 (49.0)	51.9 (50.1)
March years	2008(a)	2009	2010	2011	2012
CPI (ann % chg)	3.4	3.0 (3.1)	1.2 (1.6)	2.3 (2.2)	2.2 (2.1)
GDP (ann ave % chg)	3.1	-0.9 (-0.8)	-1.3 (0.2)	3.2 (4.8)	3.8 (3.9)

Full text of the June Policy Assessment

OCR unchanged at 2.5 percent

The Official Cash Rate (OCR) will remain unchanged at 2.50 percent.

Reserve Bank Governor Alan Bollard said: "The economic outlook remains weak both in New Zealand and in other countries. However, there are signs that international economic activity is stabilising, and international financial conditions are improving. We expect the New Zealand economy to begin growing again toward the end of this year but the recovery is likely to be slow and fragile. Many key economic indicators such as unemployment are projected to keep deteriorating well into 2010.

"There remain some material downside risks to activity and inflation, but for the first time in some months we can also identify some clear upside opportunities for activity. One such area is a potential rebound in household spending and residential investment as a result of the rise in net immigration and the pick-up in the housing market. Ultimately, however, we do not think such a rebound in spending would prove sustainable given the soft outlook for employment, wages and farm incomes and high levels of household debt.

"On balance, the risks to activity remain weighted to the downside.

"The recent rise in the New Zealand dollar creates an unhelpful tension with our projections. A stronger dollar at a time of weak global growth risks delaying or even reversing the projected increase in exports, putting the sustainability of recovery at risk.

"Overall, recent developments point to lower inflationary pressure than previously projected. Annual CPI inflation is likely to fall temporarily below the bottom of the target band later this year, but we expect it to return to inside the band by early 2010 and remain comfortably there over the remainder of the projection.

"We have cut the OCR by a large amount over the year. We expect the effects to pass through to more borrowers over coming quarters as existing fixed-rate mortgages come up for re-pricing. Although rising longer-term interest rates overseas are placing upward pressure on longer-term lending rates here, there is room for further reductions in shorter-term lending rates.

"The low OCR and stimulatory fiscal policy are the main sources of support to the New Zealand economy at present. It is likely to be some time before the recovery becomes self-sustaining and monetary policy support can be withdrawn.

"We therefore consider it appropriate to continue to provide substantial monetary policy stimulus to the economy. The OCR could still move modestly lower over the coming quarters. As we said at the time of the April OCR decision, we expect to keep the OCR at or below the current level through until the latter part of 2010."

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- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

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- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;

- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

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- New Zealand and overseas unit trusts;
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- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
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- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

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Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third

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