

Economic Preview

New Zealand

21 January 2010

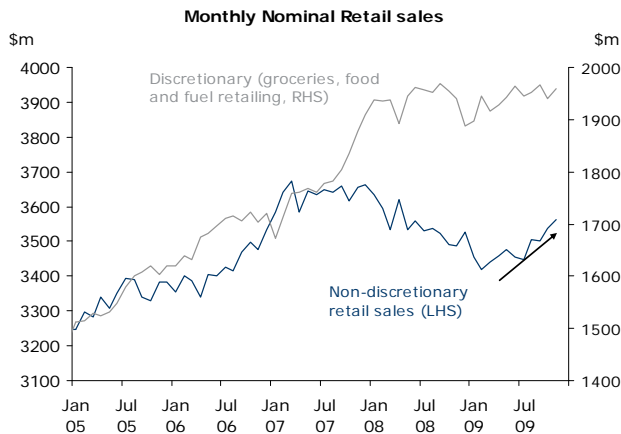
OCR Review Preview

(due 9:00am Thursday 28 January)

Key points

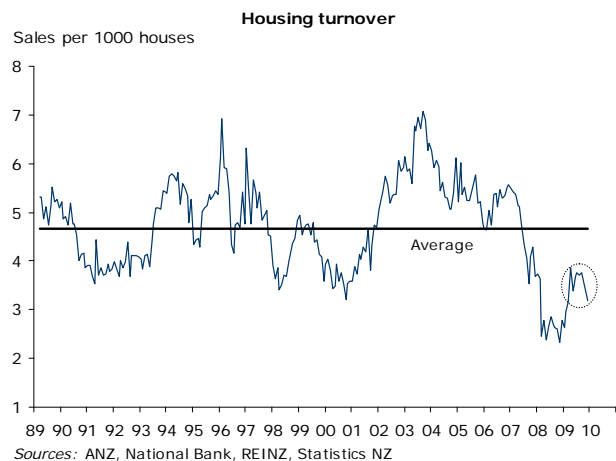
- > We expect the RBNZ to keep the OCR unchanged at 2.5 percent.
- > The RBNZ is likely to reaffirm its intention to begin tightening policy from around the middle of 2010.
- > We continue to look for the first OCR hike to commence in the June MPS, with a 50 basis point increase.

Momentum within the economy is building nicely. Household spending is likely to rebound as fears of a deeper downturn recede, construction sector activity is likely to pick-up over 2010 given a looming shortage of dwellings, inventories will need to be rebuilt from current low levels, and the capital stock will need to be replenished following a period of weak business investment. Commodity prices have continued to rise and the prognosis for New Zealand's terms of trade looks good.



We have observed continued improvement in business and consumer sentiment. This suggests some risk of a strong recovery in economic activity eventuating. **However, it needs to be remembered that the recovery is off a low starting point** and will need to be more broad based to be more enduring. Moreover, in some sectors activity remains weak. Non-residential construction is contracting sharply and the housing market weakened into year end. So while improvement in some sectors has been noticeable (retailing is a recent case), momentum in others such as housing has already started to fade. Some confidence appears to be returning towards the labour market and investment according to the

QSBO, but firms are not yet at the point where they are prepared to commit, waiting for further sustained evidence of improvement in demand.



The RBNZ will continue to closely monitor activity and inflation trends overseas. **The trading partner outlook remains one of an unevenly paced recovery.** If recent measures by the Chinese authorities are effective they are likely to purge some of the excesses of the current upswing and promote a more sustainable expansion. With the Australian economy booming, the RBA are likely to continue returning the cash rate to more neutral levels. In the US and Europe, however, there are genuine concerns over the durability of expansion after the boost from policy stimulus fades. We fully expect further bumps in the road to recovery, as developments in Greece of late testify.

There is some uncertainty over the degree of spare capacity in the New Zealand economy. We are mindful over concerns in the December MPS over the stickiness of core inflation despite below trend levels of economic activity. Elevated survey readings of capacity utilisation are likely to have raised fears that the speed limit (and degree of economic slack)

for the economy is considerably lower than previously thought.

For now, however, the RBNZ would have been reassured by the December CPI release. While the -0.2 percent quarterly CPI outturn was exactly as forecast by the RBNZ, the increase in non-tradable inflation (at 0.1 percent quarterly) was weaker than expected. Measures of core inflation were similarly subdued. Given the inherent volatility in quarterly CPI reads, we caution against reading too much into it but it would be fair to note that **while inflation has not been crushed, it has certainly been contained.**

As the RBNZ alluded to in December, financial conditions remain considerably tighter than suggested by a 2.5 percent OCR. Margins between policy and retail lending rates remain wide, the New Zealand yield curve is upward sloping with longer term interest rates closer to their historical averages, and the NZD (on a TWI basis) is close to levels assumed by the RBNZ in the December MPS. The year has started with mortgage rates already moving up, which will only extend the softening seen in housing from late last year.

We believe the level at which the OCR is likely to have a neutral impact on the economy is around 5 percent. We can infer that the RBNZ has a similar view given they noted the 100 to 150 basis point cost of funds gap over the OCR in the December Statement (and assuming an old neutral rate of 6 percent or slightly higher). This gap shows no signs of closing for now with continued upwards pressure on deposit rates at the start of the year. The shorter duration of mortgage debt also suggests that the RBNZ will be able to achieve considerably more traction when they commence tightening. **This implies that the RBNZ will have less tightening to do to get back to neutral territory, and will need to be less pre-emptive.** Given the prospect for structural changes across the economy over the coming two years we also now suspect the journey back to neutral will likely be in two stages; from 2.5 to 4 percent in the first instance, and subsequent rises six months later.

Key to the RBNZ will be the medium-term outlook for economic activity. The recent stabilisation in the housing market and low growth in household credit, despite sizeable net immigration and low short-term mortgage interest rates, is likely to be reassuring. Crucially, the outlook for household spending will depend on the labour market, with the February labour market data providing the next available read. Registered unemployed numbers continued to rise over the quarter flagging a soft Household Labour Force Survey print. While we believe that the near-term recovery will be stronger than assumed by the RBNZ (December quarter GDP is shaping up around

1 percent as opposed to the 0.6 percent assumed), we share their concerns over the medium-term sustainability of the expansion and its dependence on policy stimulus. So while we see evidence of spending picking up, housing looks to be fading. The high NZD/USD exchange rate is unlikely to favour the return to a more balance growth path, with parts of the export sector not benefiting from stronger commodity prices likely to remain under pressure.

We believe fiscal policy choices will be important. We are expecting the May Budget to continue on the path of fiscal consolidation. It will also be interesting to observe the extent to which the government adopts the recommendations of the VUW Tax Working Group. Some combination of lowering of income tax rates, higher GST and some tightening in the tax treatment of property investment appears inevitable. While these changes are likely to be fiscally neutral, they will have an impact on economic activity as behaviour adjusts. The RBNZ will also need time to assess the impact of these proposed changes.

We expect the RBNZ will note the improvement in the economic outlook in the OCR release. However, with inflation readings contained, tighter than OCR financial conditions and the prospect of tighter fiscal policy, we believe the RBNZ will have time to wait and see how the data eventuates. However, with the OCR at very low levels and the economic outlook improving, policy will eventually need to be tightened. We are expecting this to commence with a 50 basis point hike in the June MPS.

Financial market implications

At the time of writing the market had softened its stance somewhat, all but removing prospect of a March hike. Seventeen basis points is now priced in by April, and 57 by the end of June. This is slightly above our own cumulative expectations but not materially so. With the CPI release yesterday pretty well taking the heat out of the potential for a stronger tone in the OCR Review, we suspect a steady as she goes assessment will leave the market broadly where it sits.

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