Economic Research
J.P. Morgan Securities Inc.
June 11, 2009

New Zealand Economic Update

RBNZ OCR announcement

The RBNZ this morning left the official cash rate (OCR) unchanged at 2.5%. Our forecast was for a 25bp cut, although we acknowledged the decision would be a close call. Market economists were divided over whether Governor Bollard would deliver a 25bp cut, a 50bp cut, or nothing at all.

The dovish statement accompanying the OCR announcement could have supported a decision to cut the cash rate. The Governor acknowledged signs of stabilisation in the global economy and improving conditions in international financial markets, but said the risks on balance to domestic activity remain skewed to the downside, the main reason being the expected strengthening of the NZ dollar. Indeed, recent NZD appreciation has contributed to a tightening of domestic monetary conditions (chart), with the currency up 10% since the last OCR decision on April 30. Further NZD strength, forecast by the RBNZ, will hamper any export-led recovery at a time when global demand already is weak.

The Governor did, however, identify some “upside opportunities” for domestic activity, stemming from a potential rebound in household spending and residential investment thanks to higher net immigration and a pick-up in the housing market. Housing market turnover recently has increased and other indicators, such as home loan approvals, have started to point to signs of stabilisation in the housing market, though it is too early to tell whether this will be sustained. It has yet to translate to higher residential construction activity. A turn in the housing market should help boost private consumption, but any increase in consumption probably won’t be sustained given the expected rise in unemployment, which the RBNZ forecasts at 7.1% in the March 2010 quarter; this compares to our forecast of 7.5%.

In the quarterly *Monetary Policy Statement (MPS)*, also released today, the RBNZ downgraded many of its key economic indicators, including its GDP growth forecasts. In the March 2010 year, the RBNZ expects the economy to contract 1.3%, a forecast downgraded sharply from +0.2% in the March *MPS*. Private consumption is set to remain considerably weak, with the RBNZ calling for private consumption to fall 0.6% and 0.9% in the March 2009 and March 2010 years, respectively. These forecasts are slightly optimistic, in our view, given increased anxiety about job security and tighter credit conditions.

Funding pressures have, however, eased, according to Dr. Bollard. One of the reasons we believed that a rate cut would be delivered today was that it may have prevented domestic banks from raising their mortgage rates, to compensate for elevated funding costs. The Deputy Governor recently highlighted the RBNZ’s disappointment that some domestic banks had refrained from passing on cuts to the OCR, but the good news is that households refinancing their mortgages continue to move onto lower mortgage rates, a trend that will continue over the medium term.

In our view, the statement accompanying the ‘no change’ decision today left the door open to further policy easing, if deemed necessary. As in the April statement, the Governor made clear that

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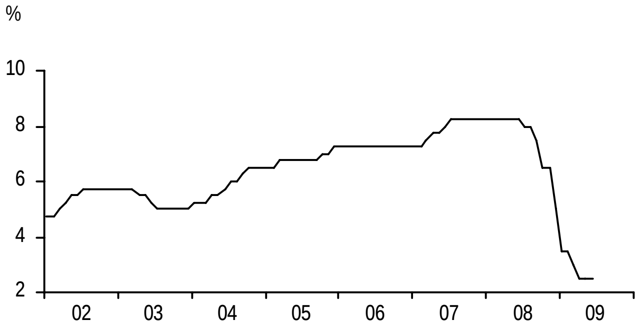
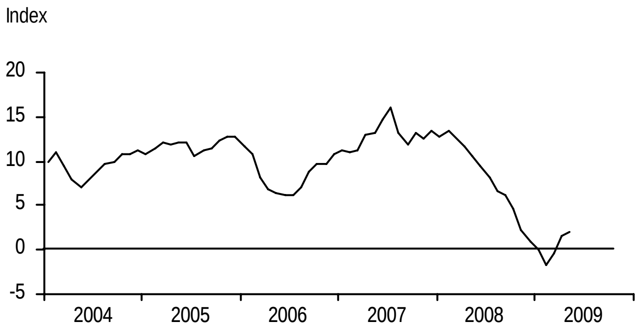
the OCR will be kept "at or below the current level through until the latter part of 2010." There is scope for further policy easing – the terms of trade is falling, private consumption is weak, and inflation pressures have eased. In fact, the RBNZ expects headline inflation to fall below its target 1-3% range later this year. We believe that headline inflation will fall below target in 3Q09.

But, the timing of the next move, if any, remains uncertain. It will take a material change in the global outlook or a significant tightening of domestic monetary conditions to trigger a further reduction the cash rate. Dr. Bollard acknowledged today that there is room for further reductions in shorter-term lending rates. Without a notable shift lower in shorter-term rates, or if doubts grow about the sustainability of recent signs of strength in the global economy, the RBNZ probably will choose to ease policy further.

New Zealand: RBNZ official cash rate



New Zealand: J.P. Morgan monetary conditions index



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