



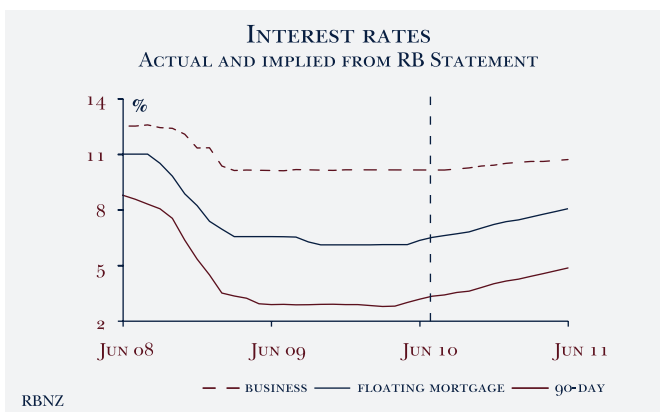
# BERL Monthly Monitor

## July 2010

### RBNZ sticks to plan A ...

This month's increase in the Official Cash Rate (OCR) indicates the Reserve Bank (RBNZ) expects NZ's economic recovery to continue essentially as forecast. As outlined in its June Monetary Policy Statement, economic growth is forecast to average 3.5% over the current March year, with consumer price inflation jumping to 4.5% in the December quarter as GST, ETS and related changes flow through the arithmetic. As a result, the RBNZ has laid out its plans for gradual increases in interest rates in an effort to unwind the monetary loosening of the past 12 months. This plan sees 90-day rates (currently 3.29%) rise to an average 3.7% in the December quarter and further to 4.6% in the June 2011 quarter.

Such a track would put a further 0.5 percentage points on mortgage interest rates (slightly less on business rates), between now and the end of 2010. A further 1 percentage point over the first half of 2011 is also in the plan. And, despite the tone of the latest announcements, it appears the RBNZ remains wedded to this plan. Consequently, while there may well be a pause coinciding with the September statement, two further 25-point increases in the OCR (in October and December) remain on the cards for later this year.

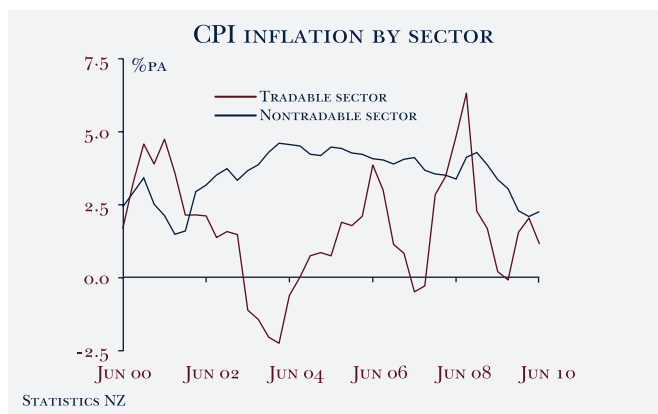


As the latest 25-points rise in the OCR to 3.00% was fully priced into the 90-day interest rate, there was virtually no effect on its current level of just under 3.3%. However, as the tone of the accompanying text was less positive than expected by many of the market players, the NZ\$ declined from 68.3 to 67.5 on the TWI.

### ... as CPI breakdown looks eerily similar

The June quarter's CPI – at 1.8% above that of a year ago – in itself should not have concerned the authorities. However, the divergence between tradable and non-tradable sector inflation is again worrisome. At 1.1% versus 2.2% respectively, the inflation control hawks are circling and beginning to provide momentum to the argument in favour of a pre-emptive strike on inflation expectations originating in the non-tradable sector. The RBNZ is likely to be particularly concerned to quickly anchor such expectations, given the potential impacts of GST, ETS and related price increases. We suspect this would have been a significant factor in the RBNZ's latest deliberations to remain with plan A.

Balancing the impacts on inflation expectations is the argument that the recovery is not as broad, or robust, as previously assessed. The state of the labour market is particularly important here. Depending on your time horizon, unemployment is either much lower than expected (6% seasonally adjusted in March, compared with 7.3% in December); or is still high (25,000 higher in actual numbers) compared with a year earlier.



This difference in time horizon flows through into one's analysis of inflationary pressures. In the former case, pressures are mounting and a pre-emptive strike is warranted. In the latter case, inflationary pressures are muted, and/or benign, and the potential growth outlook is of more concern.

Of course, the discrepancy between tradable and non-tradable sector inflation is an eerie ghost from the not so distant past. Again, though, the use of interest rates – acting through the exchange rate channel – will have little impact on non-tradable sector inflation. However, the use of interest rates will force the burden of adjustment onto the very tradable sector on which we are reliant to rectify the imbalances within our economic structure. Sound familiar?

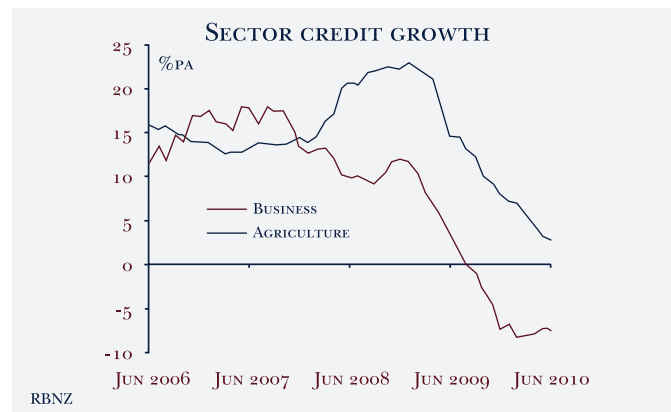
## But, credit supply is just as important as price

The RBNZ's Statement of Intent 2010-2013 details the current policy prescription in light of its assessment that the NZ economy emerged from the financial crisis better than most. Further, it is argued, the time has come for the stimulus package associated with the financial crisis to be unwound.

In general, the RBNZ's Statement portends a continuation of the policies of the past quarter century; namely, price stability as a single objective and variation of the OCR as the primary instrument. However, in recognition of "lively debate in New Zealand about the role of monetary policy in managing financial misalignments" the RBNZ is giving top priority to "investigating the potential for macro-prudential policy tools to help support the traditional OCR instrument" notwithstanding that "we are confident that medium-term price stability is the right objective for monetary policy".

This is very much in line with central bank thinking around the world as described in the IMF's recently released Central Banking Lessons from the Crisis. But, its relevance to NZ's present situation of an excessively tight credit market associated with a chronic current account balance of payments deficit and high overseas debt is arguable. Unfortunately, central banks in general seem to be intent on preparing for the next crisis, before they have finished coping with the present.

Indeed, in the NZ situation, the introduction of new regulations and macro-prudential powers to prevent future excessive credit expansion, may be worsening



the current situation. RBNZ figures for June show a continuation of the contraction of money supply and credit aggregates for the second successive month with virtually zero expansion over the year as a whole. Credit growth to business is negative as it is for consumption. Growth for house mortgages and agriculture remain positive, but at a rapidly declining rate.

The non-availability of significant credit for business is of immediate and pressing concern. Given this context, we find it difficult to believe there will be the rebound in business investment on which the RBNZ's forecast recovery hinges. From their statement this month, "Overall, we continue to predict respectable near-term GDP growth, with manufacturing confidence remaining elevated and forestry exports continuing to expand. An eventual recovery in business investment will assist growth over the medium term".

As a result, we believe the RBNZ will eventually have change tack away from plan A. But, whether that change will be quick enough to save the recovery remains a moot point.

## So, just what is leading the recovery?

Much comment has cemented in the folklore that the NZ recovery has been led by the export sector. Indeed a cursory inspection of the latest quarterly GDP numbers suggests as much. But, closer inspection of the latest data raises questions as to the 'export-led recovery' hypothesis.

SEASONALLY-ADJUSTED VOLUME MEASURES OF EXPORTS AND GDP

	EXPORTS	GDP (EXPENDITURE)	EXTENT TO WHICH EXPORT GROWTH IS ABOVE GDP GROWTH	GDP (PRODUCTION)
% CHANGE ON PREVIOUS QUARTER			% POINTS	% PQ
MARCH 2009	0.2	-0.8	1.0	-0.8
JUNE 2009	4.5	0.5	4.0	0.1
SEPTEMBER 2009	0.1	0.4	-0.3	0.3
DECEMBER 2009	-0.7	0.9	-1.6	0.9
MARCH 2010	1.4	0.6	0.8	0.6

Yes, the latest quarter shows exports growing strongly and well above the rate of expansion for economy-wide GDP. However, the previous two quarters reveal a different story, with exports contracting or growing slower than the GDP average. There have been four quarters of positive GDP growth since the end of the recession. In only two of those quarters could it be said that exports have 'led the recovery'.

Further, those two quarters are not consecutive. If one were to argue that two consecutive quarters of contractions constitutes a recession, then it would seem consistent to wait for two consecutive quarters (at least) of expansion to constitute a recovery. The GDP numbers may satisfy that criterion. But, neither the export growth numbers, nor the extent to which export growth is above GDP, satisfy that criterion. These figures do not provide convincing evidence that this is an export-led recovery.

Looking at the more longer-term numbers (to see past the erratic nature of the quarterly numbers), the growth experience over the last four quarters puts the GDP expenditure measure 0.5% higher than a year earlier (the production measure records -0.4% over the same period, highlighting measurement issues). Nevertheless, the equivalent figure for export volumes over this period is 2.8%, again suggesting an export-led recovery. However, the largest contribution by far to this turnaround in GDP over the past four quarters has been the fall in import volumes.

YEAR TO MARCH 2010 COMPARED WITH YEAR TO MARCH 2009		
	CONTRIBUTION TO GDP CHANGE \$M	% CHANGE
PRIVATE CONSUMPTION	436	0.5
INVESTMENT	-3,476	-10.2
GOVERNMENT CONSUMPTION	372	1.5
STOCK EXCHANGE	-2,464	n.a.
EXPORTS	1,163	2.8
IMPORTS	-4,767	-9.6
GDP (EXPENDITURE)	731	0.5

Even if we were to net out the change attributable to imports because of the reduction in investment (i.e. -3,476 minus -4,767) we still get a reduction in imports of \$1,291m). Admittedly, this is not entirely valid given that other components of domestic demand also impact on imports, but is presented for arguments sake. This figure implies there is still a positive contribution to GDP

from the fall in imports (i.e. 1,291) that is greater than the contribution from the rise in exports.

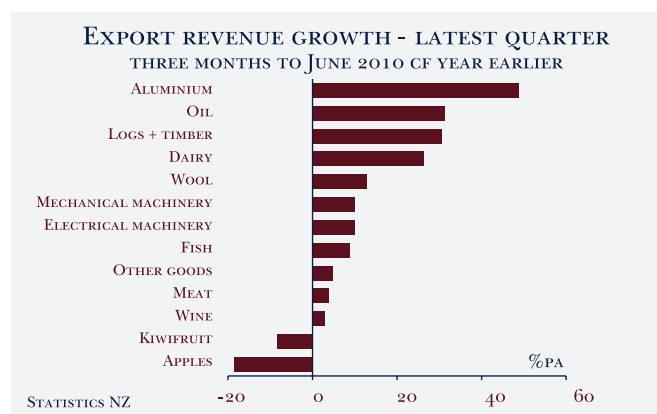
To say that exports are 'leading the recovery' is, it would seem, not the total story.

## While trade figures look promising

Overseas Merchandise Trade (OMT) statistics provide more recent data. Again, a focus on the immediate short term, will find evidence of a healthy export sector.

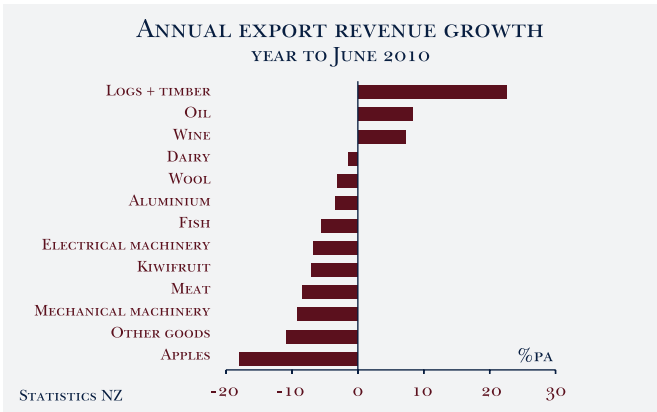
The three months to June compared with the same period a year ago, provides a positive indication of improvement, with merchandise receipts up an impressive 11.3%. However, even this total is somewhat misleading in that the breadth of the recovery is by no means widespread. That is, the average 11.3% is skewed upwards by a few very strong performers.

As per the chart, four categories (aluminium, oil, logs& timber, and dairy) record growth above this average. The two principal manufacturing (mechanical and electrical machinery) categories are also putting in an inspiring performance (up 10% on year earlier), providing some confidence about the immediate future. Of note, though, the second-top earner (meat) is well below the average. And the returns from kiwifruit and apples remain well below a year earlier, indicating a tough trading environment this season.



Again, though, a focus on one quarter's figures alone may be too short to robustly assess the nature (or state) of a recovery. This concern is highlighted by the fact that the 3 months to March 2010 registered merchandise export receipts at only 0.6% on the same period a year ago. This was despite double-digit improvements in receipts from logs & timber, oil and aluminium.

Of course, figures for the three months to March are not particularly helpful, given the seasonal absence of apples and kiwifruit exports over those months. But, this just reinforces our reluctance to rely on data



reflecting short periods, unless they are backed up by corroborating evidence from other sources.

Annual merchandise export revenue for the year to June 2010, show receipts down 4.9% on the previous year, with only three categories (logs & timber, oil and wine) recording improvements. Yes, many further categories will show significant improvements over the coming quarters (as earlier low quarters drop out of the calculation). However, the extent of the declines depicted here indicates that many categories will remain in catch-up mode over the medium term.

### Retail sector looking grim

Total retail sales for the latest three months are 3% above year-earlier levels. But, similar to the story for goods exports, the headline number masks considerable gloom at the street level.

In particular, the principal category holding retail sales growth in positive territory is motor vehicle sales and related services. But, while this category is running at 8.6% above year earlier, it is recovering from the

double-digit declines experienced through last year. Consequently, turnover remains below the levels enjoyed during the middle of 2007.

Further, retail sales across all the other categories averaged just 1.1% up on year earlier – implying significant declines in sales volumes. The non-supermarket food sector has contracted noticeably in both volumes and nominal turnover. Department stores, as well as businesses in the furniture, hardware and appliance retail sector, are also struggling in a difficult environment.

While employment and income prospects remain uncertain, we do not expect a significant turnaround in the cautious mood of households and their spending propensity.

In the immediate short term, this will be reinforced by higher mortgage payments as interest rates adjust to the latest Official Cash Rate increase. However, as has been widely reported, there is an expectation of a pre-GST rise surge in retail sales. Needless to say this will be transitory, at best.



While every effort is made to ensure that the information, opinions and forecasts included in this publication are accurate and reliable, BERL and all contributors do not accept responsibility for any errors or omissions, or for any loss or damage resulting from reliance on or the use of information, forecasts or opinions it contains