

New Zealand

UOB Economics Projections – New Zealand	2008	2009	2010F	2011F
GDP	-0.5	0.2	2.7	3.5
CPI	4.0	2.2	2.8	2.9
Unemployment Rate (year-end)	4.2	6.2	7.0	6.5
Current Account (% of GDP)	-8.7	-2.9	-7.0	-8.2

- *Indicators continue to point that the economic recovery in New Zealand is panning out broadly.*
- *Although we are maintaining our view that the NZD/USD will still see some support intact, the pair will continue taking its cues from broader trends in risk sentiment. It likely that we will continue seeing more whip-saw price action around the current ranges.*
- *While the removal of policy stimulus has begun, we still expect the pace to be gradual, and the end-point for the OCR will be lower compared to previous cycles.*

Pockets of Strength in New Zealand Economy

Indicators continue to point that the economic recovery in New Zealand is panning out broadly. Real GDP in the three months through March 2010 increased 0.6%, expanding for a fourth straight quarter on the back of growing exports. Exports increased 1.4% in the quarter, led by logs and machinery. Year-on-year, the economy grew 1.9%. Household spending, which accounts for about 60.0% of the economy, rose by 0.2% from the fourth quarter.

Consumer sentiment rose for a third month in May, climbing 3.4% to 126.0 from 121.9 in April, according to an index compiled by Roy Morgan Research and ANZ National Bank Ltd. The gauge is at its highest level since January. In terms of the labour market, New Zealand companies hired about 22,000 workers in the first quarter, and the nation's jobless rate declined to 6.0% from 7.1% the previous three months. The central bank expects employment increased by 33,000 in the first half of 2010.

The annual budget was unveiled on May 20, aimed at reducing the country's foreign debt (which is about 90.0% of GDP) by encouraging more people into work and boosting investment. For the first time in two decades, sales tax was raised and income taxes slashed to encourage household saving and reduce the "vulnerability" of a swelling foreign debt. The sales tax will increase to 15.0% from 12.5% on Oct 1, while income tax will fall for all workers from the same date, including a cut in the top rate to 33.0% from 38.0%. The sales and income tax changes are part of a broader tax reform package that includes a plan to cut the company tax rate to 28.0% next year from 30.0% currently, and a cut in the rate on trusts to 33.0%. Tax rates paid on savings will also reduce.

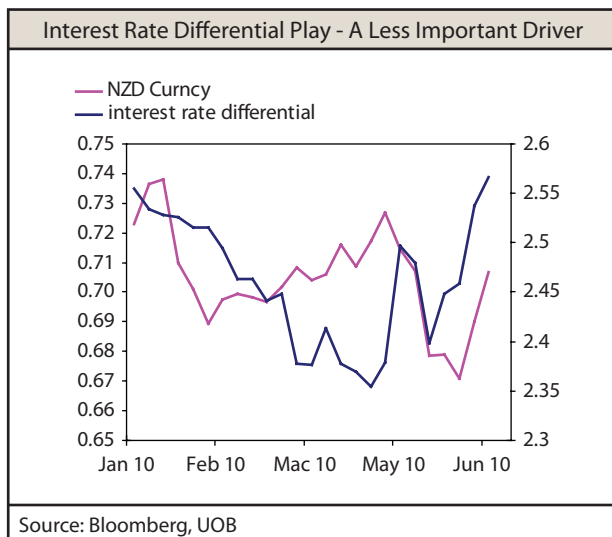
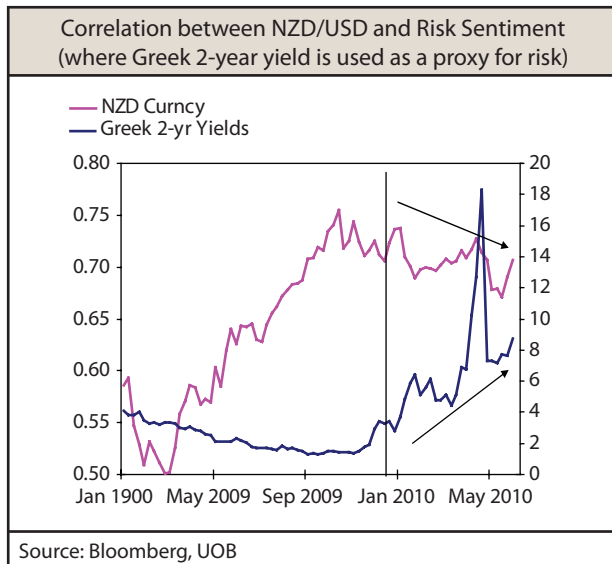
The government estimates the tax reform package will add 0.9% to GDP over seven years by encouraging more people into jobs and to work more hours. It assumes 174,000 new jobs will also be created over the next four years. Economic growth has been estimated by the Treasury to be at an annual average rate of 3.2% in the year ending March 31, 2011, stronger than the 2.4% it predicted in December. Growth will be 3.1% in the year to March 2012 and 2.9% in the following year.

Kiwi A Lot Less Rosier

We had seen a lackluster performance in the NZD/USD at the start of the second quarter, with trades congesting around the 0.7100-area. More recently, however, the currency has experienced a surge in volatility as heightened risk aversion takes centre stage amid the European debt crisis. The pair hit lows of 0.6561 in early May and is now trading around the 0.7000 levels.

We had, in the previous quarterly, taken the view that the NZD/USD would be less rosy this year. Indeed, the changes in risk appetite have seen the USD appreciating strongly, and that has sent the NZD in lower ranges. The good news is that a weaker currency is a prerequisite to the adjustment process the New Zealand economy needs to go through and for the recovery to take on a sustained look; and the authorities seem to be in favour of this. Reserve Bank Governor Alan Bollard said that the strong currency has not helped efforts to reduce the nation's large investment income deficit and overall external liabilities. He acknowledged that whilst the trade balance has improved with strong export prices and less demand for imports, a large deficit on the investment income balance is showing no signs of enduring improvement and the strong New Zealand dollar has not helped.

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And although the currency's appeal for carry traders is reinforced by a robust interest rate outlook, with markets betting that the Reserve Bank of New Zealand (RBNZ) will continue to tighten in the months ahead; we believe, however, that interest rate expectations have somewhat lost their influence and may not guarantee a sustained positive reaction in the New Zealand dollar given the current reluctance of investors to stack up on risk. Hence, no doubt that we are still maintaining our view that the New Zealand dollar will still see some support intact, but at the same time, we do bear in mind that against the larger backdrop of the recent European debt crisis, the New Zealand dollar will continue taking its cues from broad trends in risk sentiment. It is likely that we will continue seeing more whip-saw price action around the current ranges. We are looking for the NZD/USD pair to trade

around the 0.690-levels by the end of the third quarter to around 0.7000 by the end of the year.

The Rate Hike Cycle Has Begun

The RBNZ commenced its tightening cycle in June, raising the official cash rate by 25bps to 2.75%. The move – the first since April 2009 and the first increase since July 2007 – was in contrast with central banks around the region (Indonesia, Thailand and the Philippines) who had kept borrowing costs unchanged because of the Europe's debt crisis. Even its fellow neighbour, the Reserve Bank of Australia, had on June 1 also kept its overnight cash rate target unchanged, pausing after six increases since October.

Whilst the decision on June 9 in itself was widely expected, the overall tone of the statement was notably more upbeat, indicating that growth is robust and becoming more broad-based. The Bank said record-low interest rates had delivered an "extraordinary stimulus" to the economy and it was now time to start gradually withdrawing it, adding that Europe's debt crisis is having limited impact on trade and bank funding.

Besides, one of the main reasons underpinning Bollard's decision was the threat from rising prices. He is required to keep average inflation between 1 percent and 3 percent, but inflation is forecast by the central bank to soar to 5.3% next year as an increase in sales tax boosts prices. Prices increased 2.0% in the year ended March 31, 2010. On May 20, Finance Minister Bill English announced the nation's sales tax rate would rise to 15.0% from 12.5% effective Oct 1, boosting all prices by slightly more than 2.0%. The government had previously increased taxes on tobacco, while a plan to levy carbon emissions will boost fuel and power costs from July 1.

That said, the RBNZ expects it will not need to raise the cash rate as high as in previous cycles because bank funding costs are higher, long-term interest rates are higher than short-term interest rates, and a greater proportion of borrowers use floating rate mortgages. The Bank has also noted that there will remain considerable uncertainty over the pace at which policy support will be removed, with the RBNZ also explicitly noting that "further removal of stimulus will be reviewed in light of economic and financial market developments".

Hence, while the removal of policy stimulus has begun, we still expect the pace to be gradual, and the end-point for the OCR will be lower compared to previous cycles. Our projection is for three further 25bp hikes, taking the OCR to 3.5% by the end of the year.