

## OCR View Change – going cold turkey

- We are bringing forward our expectations for the start of the easing cycle.
- We now expect the Reserve Bank to cut the OCR in March 2008.
- This change of view is necessitated by what we consider to be a fundamental shift in the balance of risks facing the economy, despite booming commodity prices.

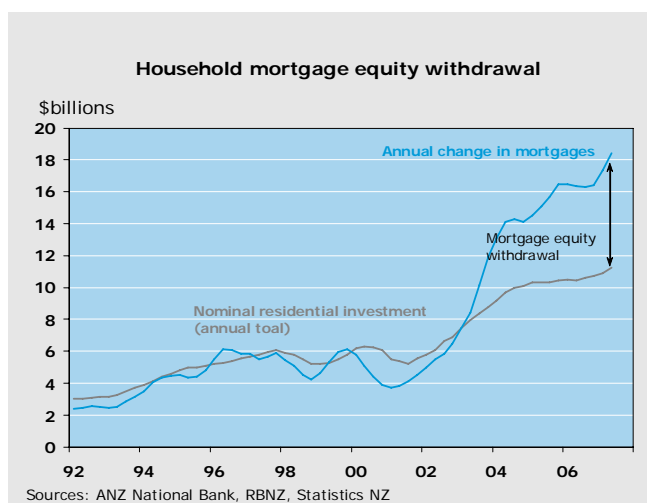
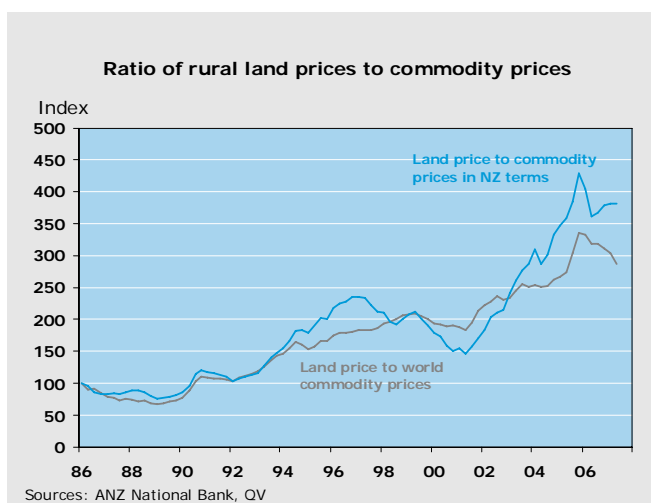
We are bringing forward our expectations for when the Reserve Bank will start the easing cycle, from late 2008/early 2009 to March 2008. The late 2008 or early 2009 easing cycle view was implicitly a recognition that in the absence of a significant development, rates were likely to be held higher for longer.

Our view change has been prompted by what we see as a fundamental shift in the balance of risks facing the New Zealand economy. In light of this altered risk profile we have brought forward our expectations towards the timing of the easing cycle.

- **The economy is at a very vulnerable stage of the cycle**, due to the extent of imbalances in the economy and the amount of leverage in the household sector. While growth over the past five years has been driven by solid fundamentals such as strong commodity prices, profitability, infrastructure investment and income, there has also been prodigious growth in leverage with households' debt servicing burden rising from 100 to 161 percent of disposable income between 1999 and 2007, and the current account ballooning to 8.5 percent of GDP (although easing recently). The crux of recent global financial market volatility resides in a reassessment of investment risks, and New Zealand is heavily indebted and reliant on offshore capital.
- **The global environment contains a greater degree of uncertainty.** Historically it has been fundamental shifts in the global environment that have typically been the *coup-de-grâce* on New Zealand's economic dislocation – the 1987 stockmarket crash, the global recession of the early 1990s and the Asian crisis of the late 1990s being prime examples. At this stage, global unease remains contained to the US, and the Federal Reserve has moved quickly to shore up confidence and provide support. However, we expect financial markets to remain volatile. There seems to be a game of chicken developing between financial markets banking on the Fed to underpin risk appetites, and the Fed attempting to strike a fine balance between allowing accurate pricing of risk and emerging economic risks.
- **Financial conditions in the domestic economy have tightened further, at a time domestic demand is showing signs of easing.** House sales, house prices, borrowing and consumer spending are slowing – both in terms of timely data, and more strongly based on anecdotes. While commodity prices, employment, wages and government spending are certainly pillars of support, consumer spending and the housing market are the key areas of domestic demand the Reserve Bank has been seeking to quell. At the same time, financial conditions in the domestic economy have tightened via a widening in swap spreads, credit spreads and the rise in the 90-day rate. Funding pressures remain given the spread between the 90-day rate and the Official Cash Rate (it was as high as 90 basis points at one stage). Remember the MCI?
- **We are very wary of the role the credit channel of monetary policy could play at the end of the economic cycle.** There has been a strong credit accelerator at work supporting growth and adding to inflation over the past five years, implicitly working against the Reserve Bank's efforts. The combination of abundant liquidity, narrow spreads and strong risk appetites has been a key supply side phenomenon driving credit growth. Asset prices (notably housing) and markets have been caught up in a circle of success where liquidity drives asset prices, the ability to leverage drive deals and returns, resulting in real economic momentum, which leads to more liquidity driving asset prices and scope for leverage... and the spiral is in motion. Housing credit growth has averaged almost 15 percent per year for the past five years, and lending from non-bank financial institutions has averaged closer to 19 percent. This credit accelerator has the potential to turn into a strong credit decelerator given the combination of reassessed global risk, funding pressures in certain pockets, altered risk appetites, leverage, and repricing of risk domestically.

- **We can no longer ascribe a zero probability to recent signs of dislocation across non-bank financial institutions turning into a systemic issue.** This is despite the financial system being fundamentally strong. The experience of the US shows that events do tend to escalate, particularly when investor confidence disappears.

**Admittedly, there is still support being provided to growth from strong commodity prices and fiscal spending.** The potential increase in the dairy payout for the current season could potentially be equivalent to 1.5 percent of GDP, while the fiscal impulse is equivalent to 1.6 percent of GDP for the 2008 fiscal year. Both are strong and important floors to growth. The NZD has eased, thereby loosening monetary conditions for the export sector. However, we note that commodity price gains are already strongly capitalised into rural land prices (with a commensurate rise in debt levels). A fall in commodity prices could see the strongest pillar of growth giving way quickly. A lot depends on how the US economy unfolds, and if in a negative fashion, whether the global economy has truly decoupled from the US. Sure, dairy prices contain a heavy supply support factor. But we are suspicious of how long this can persist given price signals, how consumers are likely to respond if the price of dairy goods moves up (the price elasticity of demand) and whether Asia can remain immune to the global financial volatility.



**The big unknown at present is the degree of non-linearity in the household sector in relation to debt levels.** Households have shown remarkable resilience so far in the face of rising interest rates. We are in uncharted territory when looking at the debt servicing burden, which has reached unprecedented levels of close to 14 percent of disposable income (which is more extended than US households). While difficult to display empirically, we strongly suspect there is a heavy non-linearity in the interest rate effect. That is, households are ambivalent until an “event” occurs, and a tipping point is reached. Recent global unease certainly bears all the hallmarks of an event in terms of creating volatility and leading to a fundamental reassessment, this time towards risk.

**Diminished credit and easing house prices are likely to have a massive impact on the economic cycle.** The asset, credit, real economy and liquidity related spiral could quickly unfold. While employment growth (which everyone believes is a critical support factor for ensuring the cycle continues) remains strong, the US subprime experience shows that a turn in the labour market need not be a pre-condition. Indeed, in an environment where risk appetites are flaky, risk is being repriced and moral hazard issues emerge, the cycle of success (or excess) could quickly unfold. We note:

- There has already been \$1 billion of savings put at risk by various finance industry related collapses over the past year. There is speculation of more to come. The flow-on confidence effect is expected to be non-trivial. At a minimum, we expect to see diminished lending from the sector which has helped to fuel consumer spending, particularly in durable goods, in the past few years.
- The financial wealth effect on consumption is huge in New Zealand. It is estimated that in the long-run, a 10 percent decline in financial wealth (from equity or other forms of savings) will result in a 2 percent decrease in consumption. The wealth effect from housing is of a similar magnitude, but consumption growth tends to respond sooner to changes in housing wealth.
- The mortgage equity withdrawal factor has been a key vehicle from which households have been able to unlock the value of their houses to fund consumption in the past few years. Mortgage equity withdrawal totalled over \$7 billion in the year to June 2007 – the equivalent to 7½ percent of

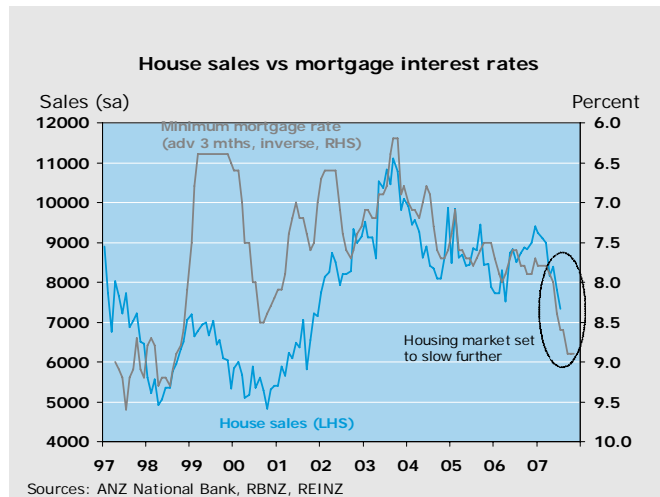
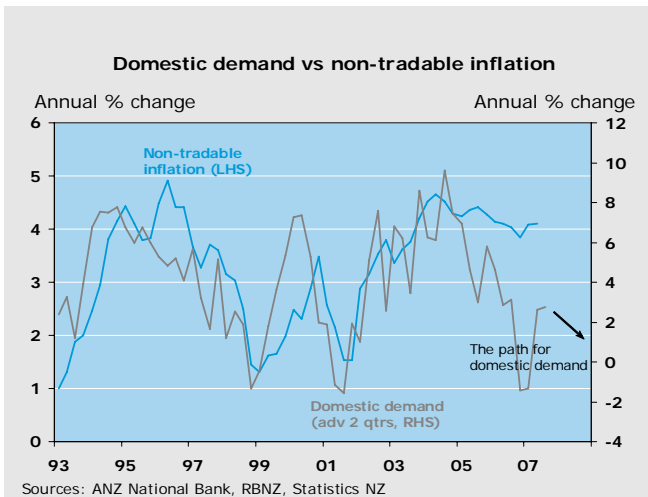
household consumption. A pullback in this alone over the next few years has the potential to lead to a subdued period of consumption growth ahead.

- Those heavily geared into housing are critically reliant on rising house prices, given interest rates of 9 percent and average rental yields of between 4 and 4½ percent. At a minimum, a flattening housing environment – what we are already in – limits the scope to re-leverage into subsequent investment opportunities.

**Certainly, inflation remains a sticking point to when the Reserve Bank will feel comfortable easing rates.** We remain wary over inflationary pressures given the tight labour market and the persistence of non-tradable inflation in the near-term. We expect non-tradable inflation to rise slightly to peak at around 4.3 percent for the December quarter, before receding from the March 2008 quarter. The recent decline in the NZD, if sustained, will also add further tradable inflation pressure and increases the chance of headline inflation going above 3 percent early next year.

**However, stepping back:**

- **Domestic demand is the key driver of non-tradable inflation** and the main drivers (leverage, debt servicing, confidence, easing house prices), excluding late cycle support from the labour market, are pointing lower. Speculative bubbles or irrational exuberance do not unwind in an orderly fashion. A booming export industry in 2000 (including the rural sector) did not stop a domestic recession.
- **What is fundamentally different to the last period of economic softness** (early 2006) is that the credit channel of monetary policy and supply of credit to some key pockets of the economy are likely to be working in the Reserve Bank’s favour. Lacking the “credit” fix, it may well be a case of cold-turkey, particularly if assets from stressed sectors need to be unloaded in an environment of easing asset prices. The speculative and investment property markets are likely to be vulnerable.
- **The New Zealand economy has shown a tendency to turn sharply in the past, particularly when it is at a vulnerable stage in the cycle.** Domestic demand is set to slow markedly over the remainder of this year. We believe recent global volatility and its effect on risk repricing are set to have a material impact via the credit channel.
- **As the US Federal Reserve’s recent about-face shows, inflation concerns take a backseat when financial dislocation is apparent and real economic activity comes under threat.**



**From a broad macroeconomic perspective, we expect the traditional shock-absorbers (a weaker currency and inverted yield curve) to play a key role** in dampening potential second-round effects on signs of economic dislocation. Liquidity remains strong albeit its price is being reassessed. Stresses in some pockets also present opportunities.

**For now, we are looking at three 25bps cuts to the OCR in March, April and June 2008.** We expect the Reserve Bank to then pause to assess the dataflow, before resuming the easing cycle from early 2009. While we acknowledge the strong support being provided to the economy via commodity prices, and inflationary pressure, we believe recent developments have altered the risk profile for the economy, and our new interest rate profile reflects the new balance of risks.

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