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## **RODNEY'S RAVINGS**

International financial linkages and NZ's latest monetary policy experiment

### **EXECUTIVE SUMMARY**

The financial crisis has resulted in the NZ share market and the exchange rate becoming closely linked to international developments (e.g. if the US share market goes up/down overnight the odds are heavily in favour of the NZ share market and the NZD/USD also rising/falling). However, this has not always been the case and people are ill-advised to assume the new linkages will be the norm forever. Quality analysis of financial market and economic prospects remains critical, even if the unwary are tempted to rely on the transitory rule of thumb that NZ developments are inexplicably tied to international developments.

In that context, there is an "interesting" divergence in monetary policy emerging between New Zealand and Australia. By "interesting" I mean "worrying". While the Reserve Bank of Australia has started to "lessen gradually the degree of monetary stimulus" so as to "increase the sustainability of growth in economic activity and keep inflation consistent with the target over the years ahead", the RBNZ has decided to keep the foot firmly on the accelerator. Governor Bollard should have learnt that excessive stimulus to economic growth only causes pain down the track, but it seems the governor is quite willing to risk subjecting us to another boom-bust economic cycle if only to prove that he is smarter than the financial markets. This is a time when quality analysis, like that offered in our competitively-priced pay-to-view reports is more important than ever because this is definitely a case when being forewarned provides money making opportunities.

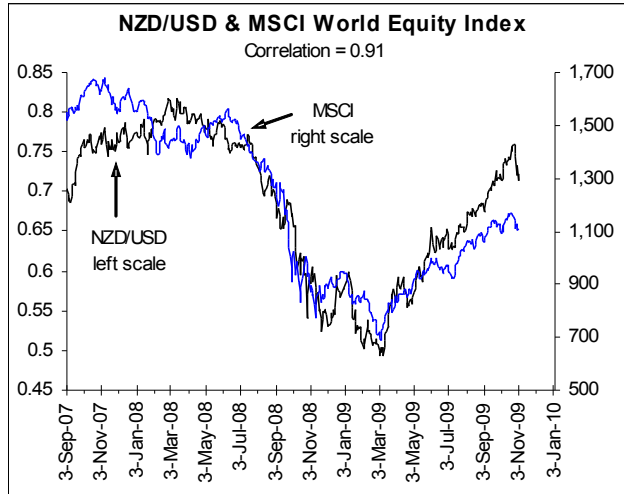
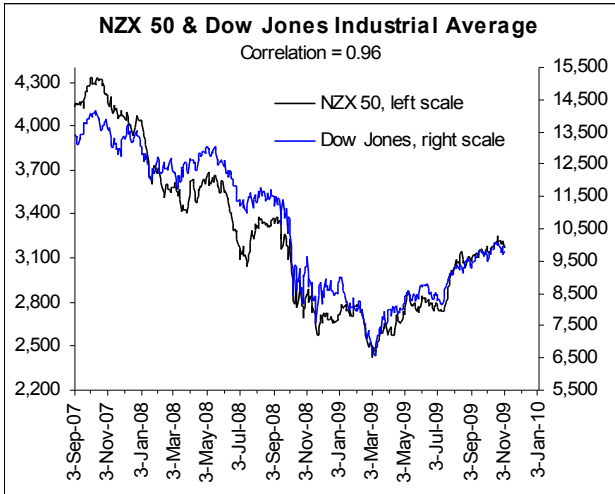


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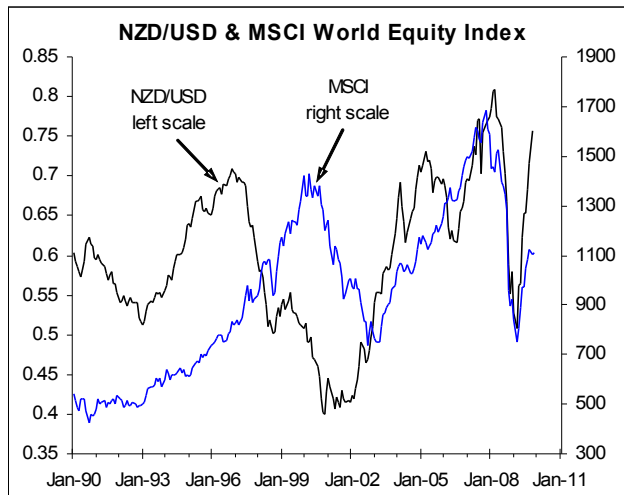
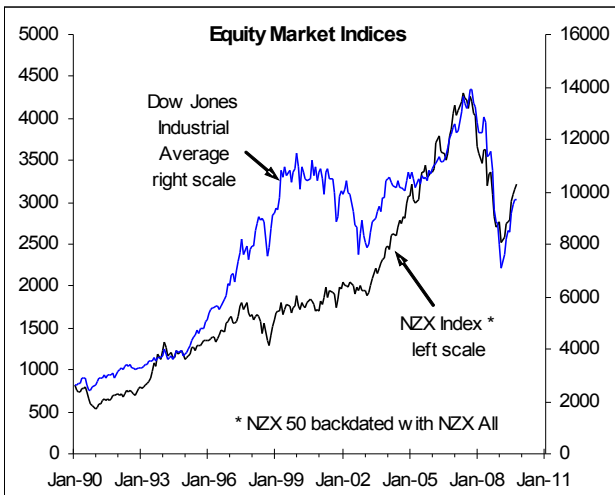


**The financial crisis has dictated the tone of NZ markets**

Since the international financial crisis started in 2007, and especially since it escalated post the bankruptcy of Lehman Brothers in September 2008, the overnight performance of the overseas markets has largely dictated what happens in the NZ share market and with the NZD/USD the next day. If the overseas markets have a good night it is almost a sure bet that the NZ share market will gain ground and the NZD/USD will appreciate, and vice versa if the overseas markets have a bad night. This linkage is reflected in the extremely high correlations between the NZX 50 share market index and the Dow Jones (left chart) and between the world equity market and the NZD/USD (right chart).



It is common for people to form expectations about the future based on recent experience even though recent experience can at times be a poor guide to future behaviour. The NZ share market won't necessarily remain linked to the fortunes of the US share market, with the left chart below showing both the recent close relationship and a major difference in performance between 1995 and 2002. Similarly, the right chart below shows that in the relationship between the NZD/USD and the world equity market has for extended periods been totally different to the recent cosy one.



**Could the linkages breakdown?**

This Raving doesn't supply conclusive answers. Rather, it encourages people to keep an open mind and most importantly to keep doing homework on what really matters to markets rather than falling back on rules of thumb like the rule that what happens overseas will be the key to NZ market behaviour. If there are fundamental differences in the key drivers of markets then ultimately the fundamentals will out. In that context, there is an interesting divergence in monetary policy emerging between New Zealand and Australia. This was discussed in the recent Raving titled ***"Should Australia take over NZ monetary***

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**policy**" (see the following link for that report - <http://www.sra.co.nz/pdf/MonetaryPolicy.pdf>). As discussed in the recent Raving, the key leading indicators are pointing to NZ and Australia both experiencing strong rebounds in economic growth, while both countries are facing a high exchange rate and leading indicators of inflation are similarish in both countries. These similarities suggest that similar monetary policy decisions should be unfolding in the two countries.

On 29 October Governor Bollard stuck to the view that "a very gradual increase in household spending appears to be taking place" and that "The forecast recovery in economic activity is based on fiscal and monetary policy continuing to provide substantial support to the economy. We think such support remains appropriate." While Bollard continues to largely dig his toes in over when OCR hikes will begin: "In contrast to current market pricing, we see no urgency to begin withdrawing monetary policy stimulus, and we expect to keep the OCR at the current level until the second half of 2010." However, his thinking has evolved with "the second half of 2010" replacing the previous "late 2010". There was also the comment: "Further ahead, removing some of the current fiscal stimulus is likely to reduce the work that monetary policy will otherwise need to do." See <http://www.rbnz.govt.nz/news/2009/3793883.html> for the Governor's pearls of wisdom.

By contrast, the Reserve Bank of Australia (RBA) followed up the 0.25% hike in the Aussie cash rate delivered on 7 October with another 0.25% hike to 3.5% effective 4 November. The RBA's media statement concluded with the following comments: "With the risk of serious economic contraction in Australia now having passed, the Board's view is that it is prudent to lessen gradually the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker. The adjustments at the October and November meetings will work to increase the sustainability of growth in economic activity and keep inflation consistent with the target over the years ahead." See the last page for the full statement if you want to read some quality comments by a central bank governor with an eye for trying to stabilize economic growth rather than promote boom-bust cycles.

NZ has a proud history of being a trend-setter and forging its own destiny (e.g. women's suffrage and nuclear free vegemite sandwiches). However, NZ has also been a trend setter in trying silly monetary policy experiments that have caused more pain than good, like the monetary conditions index (MCI) that put too much emphasis on the level of the exchange rate. Unfortunately, in my considered opinion, Governor Bollard's current attempt to try a new approach to monetary policy is just a repeat of his misplaced "go for growth" approach first adopted in 2003 that merely resulted in the economy being subjected to a damaging boom-bust cycle. This is one case in which following the lead of the Australians, who have a much better track record at running monetary policy than the RBNZ, is a good idea.

Even some of the bank economists are starting to wake up to the implications of Governor Bollard's stubbornness to start gradually removing the massive monetary policy stimulus, as evidenced by the following extract from an article on 2 November:

**"Late and hard" rather than "early and gradual" is the prediction on how the Reserve Bank will move when it eventually hikes cash rates, this week's economic commentaries suggest.**

**by Sonia Speedy**

The **Westpac Weekly Commentary** says recent comments from the RBNZ strongly hint that it is leaning towards moving "late and hard". This would put it at odds with other central banks favouring a more pre-emptive approach, particularly with policy rates still at "emergency settings".

"The Reserve Bank of Australia (RBA) and Norges Bank have begun raising rates on this basis, European Central Bank officials have commented on the need to act early, and there's even speculation that the Fed will look at rewording its commitment to low rates at this week's review," it says.

Westpac believes that the RBNZ will have started moving rates by March and also comments that with six-month fixed mortgage rates having now risen, there is now no point on the mortgage curve that appears to be "safe".

Source: <http://www.mortgagerates.co.nz/article/976495871/no-point-on-mortgage-curve-safe-now.html>



Boys with toys will be boys with toys and all that, but it is a pity when the toy in question is something as important as the OCR. However, if history has taught me anything it is that my long-standing campaign for more stable interest rates (and by implication more stable economic growth and a more stable exchange rate) has no impact on NZ monetary policy decisions. So rather than lose sleep over dubious monetary policy decisions by the RBNZ my focus is on helping clients of our regular pay-to-view reports take advantage of the folly. Most importantly at the moment I am advising clients to gear up for the good times that are starting to unfold, but equally to store up lots of acorns during the period of strong growth because Bollard's "go for growth" approach will continue to mean famines follow feasts. The implications for interest rates, economic growth, consumer spending, labour costs etc are discussed in detail in the monthly **Interesting Times** reports, the implications for the housing market are covered in the **Housing Prospects** and **Building Barometer** reports, the six weekly **Monetary Policy Briefing** reports offer more detailed critiques of the RBNZ's folly, while the twice monthly **Forex Prospects** reports look at the implications of local and international developments for the exchange rate. Any firms serious about business risk management shouldn't be without these reports.

### **The Voice of Reason – RBA Media Release**

The following is the media release by the RBA delivered on 3 November 2009.

#### **STATEMENT BY GLENN STEVENS, GOVERNOR**

At its meeting today, the Board decided to raise the cash rate by 25 basis points to 3.5 per cent, effective 4 November 2009.

The global economy has resumed growth. With economic policy settings likely to remain expansionary for some time, the recovery is likely to continue during 2010 and forecasts have been revised higher. The expansion is generally expected to be modest in the major countries, due to the continuing legacy of the financial crisis. Prospects for Australia's Asian trading partners appear to be noticeably better. Growth in China has been very strong, which is having a significant impact on other economies in the region and on commodity markets. For Australia's trading partner group, growth in 2010 is likely to be close to trend.

Sentiment in global financial markets is much better than earlier in the year. Nonetheless, the state of balance sheets in some major countries remains a potential constraint on their expansion.

Economic conditions in Australia have been stronger than expected and measures of confidence have recovered. Some spending has probably been brought forward by the various policy initiatives. With those effects now diminishing, these areas of demand may soften somewhat. Some types of capital spending are likely to be held back for a while by financing constraints, but it now appears that private investment will not be as weak as earlier expected. Medium-term prospects for investment appear, moreover, to be strengthening. Higher dwelling activity and public infrastructure spending are also starting to provide more support to spending. There have been some early signs of an improvement in labour market conditions. The rate of unemployment is now likely to peak at a considerably lower level than earlier expected.

Inflation has been declining for the past year. In underlying terms, inflation should continue to moderate in the near term, but now will probably not fall as far as earlier thought. Headline CPI inflation on a year-ended basis has been unusually low because of temporary factors, and will probably rise somewhat over the coming year. Both CPI and underlying inflation are expected to be consistent with the target in 2010.

Housing credit growth has been solid and dwelling prices have risen appreciably this year. Business borrowing has been declining as companies have sought to reduce leverage in an environment of tighter lending standards. For many business borrowers, increases in risk margins are still coming through. The decline in credit has been concentrated among large firms, which have had good access to equity capital and, more recently, to debt markets. Share markets have recovered significant ground.

The Board noted that the rise in the exchange rate is likely to constrain output in the tradeables sector and dampen price pressures. Nonetheless, growth is likely to be close to trend over the year ahead and inflation close to target. With the risk of serious economic contraction in Australia now having passed, the Board's view is that it is prudent to lessen gradually the degree of monetary stimulus that was put in place when the outlook appeared to be much weaker. The adjustments at the October and November meetings will work to increase the sustainability of growth in economic activity and keep inflation consistent with the target over the years ahead.

Source: <http://www.rba.gov.au/MediaReleases/2009/mr-09-25.html>

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