▪ New Zealand

UOB Economics Projections	2007	2008F	2009F	2010F
GDP	3.1	-1.0	-1.7	2.2
CPI	2.4	4.0	1.9	2.1
Unemployment Rate (%)	3.7	4.2	6.1	7.0
Current account (% of GDP)	-8.2	-9.0	-6.9	-6.2

The New Zealand economy seems to have gotten past the worst point of the cycle. Real GDP unexpectedly rose by 0.1% in the second quarter – the first time in six quarters – following a 0.8% drop in the first quarter.

We expect the NZD/USD to move in tandem to the stronger AUD/USD. Markets' expectations for a global recovery should lead to a rise in commodities, adding to the support in the NZD/USD as well.

However, the appreciation in the NZD poses a risk to the already-large external imbalance and if the NZD continues to strengthen, this could potentially stifle the projected recovery in exports and hence overall activity.

We see the OCR remaining at 2.50% for the rest of this year before the RBNZ takes on a hawkish gear some time in the second quarter of 2010.

New Zealand Economy: Getting Past the Worst Point

Real GDP unexpectedly rose by 0.1% in the second quarter – the first time in six quarters – following a 0.8% drop in the first quarter. Year-on-year, GDP shrank by 2.1% in Q209 from a decline of 2.6% in Q109. It does seems that the New Zealand economy has gotten past the worst point of the cycle, though the RBNZ had previously mentioned that the economy would begin to recover only in the final quarter of this year.

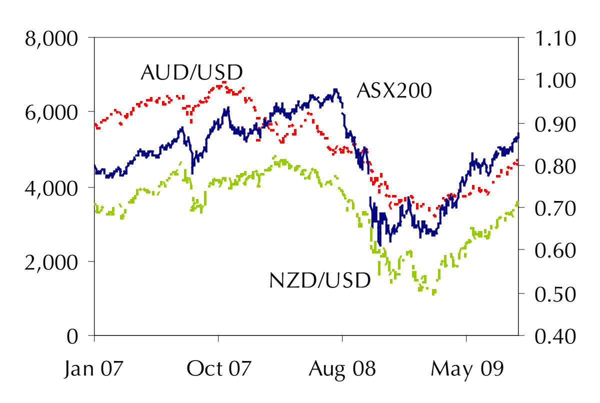
While positive developments on the global front have been the most significant factor for New Zealand, indicators in the third quarter have also suggested that the domestic economy has stabilised. Both business and consumer confidence have improved. According to a survey by Westpac Banking Corp. and McDermott Miller Ltd., the household sentiment index climbed to a four-year high of 120.3 in the third quarter from 106.0 in the second quarter. Meanwhile, business confidence rose to 34.2 in August, the highest level in four years. Activity in the housing market has also improved since the beginning of this year.

Nonetheless, the country has yet to show evidence of sustainable recovery. While there have been signs that spending by households and businesses has picked up on the back of lower interest rates, it remains to be seen whether domestic consumption and spending will be prolonged, given that the labour market will continue to remain weak for some time. Unemployment rate has climbed to 6.0% in the second quarter of 2009 and has not, in our point of view, peaked. We see jobless rate rising to about 7.0% in 2010 as firms are likely to remain cautious in their hiring and investment decisions. Furthermore, any positive developments at home are likely be offset by the appreciation of the NZD that would cloud the outlook for exports and tourism, which together accounts for about 40% of the economy.

Persistent Strength in Kiwi a Threat to the New Zealand Economy

Apart from the return in global risk appetite, the commodity-laden currencies have also benefited from the steady rise in commodities, pulling up the Kiwi along with the Aussie and the Loonie. Over the last quarter, NZD/USD took on a steady ascent from lows of 0.6197 on 8 July to highs of 0.7312 on 23 September, making it the best performer against the dollar out of 16 major currencies in the quarter. The NZD has also moved in line with the performance of global equity markets which have improved on early signs of stabilisation and improved confidence.

Correlation Between NZD/USD, AUD/USD and ASX200



Source: CEIC

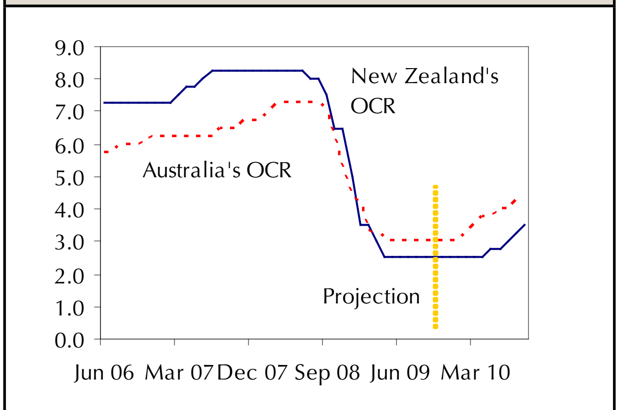
With regards to price developments, the New Zealand dollar's performance is typically influenced by Australia, its biggest trading partner. As such, we expect the NZD/USD to move in tandem to the stronger AUD/USD. Furthermore, New Zealand's merchandise exports are heavily weighted to soft commodities such as dairy prices. And although the rebound that has occurred recently in global commodity prices has not largely been due to higher prices in soft commodities, Fonterra (the world's largest exporter of milk powder, butter and cheese) has recently raised its forecast for milk prices by 12%, citing a strong recovery in mild powder prices from the five-year low attained in July. Apart from the rise in global dairy prices, markets' expectations for a global recovery should lead to a rise in the prices of other commodities, adding to the support in the NZD/USD as well.

Nevertheless, the recent strength in the NZD has continued to come under the attention of the authorities. At its latest September meeting, the RBNZ stated that recovery could be put at risk if the NZD continues to strengthen. Indeed, the persistent rise in the currency will likely put pressure on New Zealand exports for awhile, resulting in weaker export growth, and thus putting the sustainability of the recovery at risk. The RBNZ's comments were in a similar vein to those of Finance Minister Bill English who said earlier in the month that gains in the currency "appear to be out of line with New Zealand's fundamentals" and has "curbed returns for exporters". He had also mentioned in August that he wants growth to be driven by exports (constituting to about 30% of GDP) rather than consumption and borrowing. While the Bank has pledged to reassess policy settings if necessary, Reserve Bank Governor Alan Bollard has admitted that little can be done to stem the currency's rise.

We Look for the OCR to Stay at Current Levels

The official cash rate was held unchanged – for the third consecutive time – at 2.50% at the September meeting. Bollard said "there is more evidence that the decline in economic activity is coming to an end, and that a patchy recovery is underway". While his speech suggested a more positive view on the economy compared to the June Monetary Policy Statement, the central bank stuck to the dovish ending whereby "we continue to expect to keep the OCR at or below the current level through until the latter part of 2010".

New Zealand's OCR vs Australia's OCR



Source: CEIC, UOB

The appreciation in the NZD poses a risk to the already-large external imbalance and if the NZD continues to strengthen, this could potentially stifle the projected recovery in exports and hence overall activity. As such, whilst the positive effects of the fiscal lift and accommodative monetary policy are slowly becoming more evident, the recovery is still forecasted to be gradual and modest.

Given the favourable inflation outlook in the New Zealand economy as well as the question on sustainability and the pace of recovery, the RBNZ in our opinion, will not withdraw its monetary policy support. We see the OCR remaining at 2.50% for the rest of this year. Nevertheless, with expectations that the Australian central bank may hike rates sooner than the other major central banks, we see the RBNZ following suit some time in the second quarter of 2010 given that is share many of the RBA's interests.