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NZD Plummets on Political Change

- **NZD falls on uncertainty**
- **Potentially putting upward pressure on future rates**
- **Fiscal policy to ease**
- **More debt to be issued**
- **Growth on a firm footing**

NZD hit by political uncertainty . . .

The New Zealand dollar has tumbled. This largely reflects a combination of heightened uncertainty surrounding the policy mix of the incoming government coupled with fears that New Zealand First leader Winston Peters will push for a change in monetary policy settings such that a weaker NZD becomes a focus of policy.

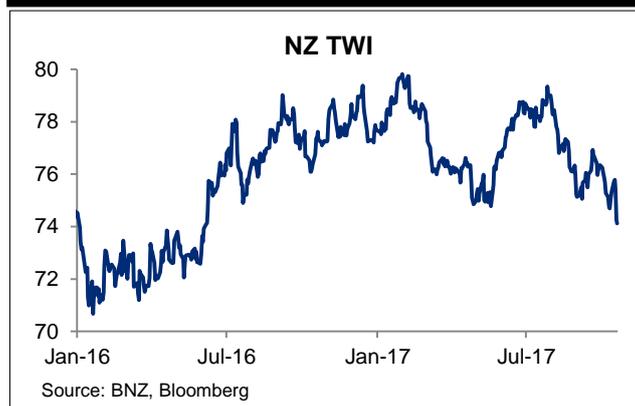
We had cautioned ahead of the election that this was a likely reaction to a change in Government. However, we also cautioned that there was a real risk that any such reaction would get overdone. We may well be reaching that point with the NZD stretching further below our fair value model estimate of USD 0.73.

But fixed interest markets unfazed . . .

Interestingly, fixed interest markets have actually rallied modestly. This means there is currently something of a disconnect between the interest rate and foreign exchange markets. At current levels, the TWI is 5% below that assumed by the RBNZ when it produced its August MPS. All things being equal, this would argue for a 0.5 percentage point increase in its year-ahead CPI inflation forecast and an interest rate track around 50 basis points higher. Clearly, all things are not equal but it goes without saying that the longer the NZD stays at these levels, the greater will be the upward pressure on interest rates. It seems then that the initial market reaction is to price in a lower growth outlook. Something we are not, at this stage, subscribing to.

So, we know that we now have a Labour-NZ First government, with the Greens supporting that government in confidence and supply. But there remain a huge number of questions as to what the policy mix of that government will be. We know that Labour will be the dominant party and what the broad thrust of its policy is. What we don't know is the full extent of the concessions it has had to make to operate alongside New Zealand First. We will get more information on this across the course of the day and substantial detail has been promised for early next week.

NZD Stumbles



Labour policy drives the agenda . . .

As we wrote in our pre-election briefing, compared to the outgoing regime, Labour will:

- run looser fiscal policy;
- necessitating a larger debt programme (Labour says it will issue \$7bn more debt over the next four years than was in National's mandate);
- be more redistributive in its approach to taxes and spending;
- government building of "affordable" housing will start almost immediately;
- implement a higher minimum wage;
- transition to free tertiary education and higher student allowances;
- generate modestly more inflation;
- expand the Policy Targets Agreement to include employment as a target;
- ensure that monetary policy decisions will be made by a committee dominated by Reserve Bankers but including independent members;
- publish the minutes of that committee;
- keep the age of superannuation at 65; and

- endeavour to resume payments into the New Zealand Super fund.

Much of the above is supported by NZ First which will also look to:

- reduce net immigration;
- impose tighter rules on foreign ownership, especially the foreign purchase of existing homes and it will be interesting to see how the foreign ownership rules impact New Zealand's free trade objectives – particularly, in the first instance, TPP;
- moderate some of Labour's policies which were seen as anti-business especially the proposed water tax for the agriculture sector.

In acknowledgement of the Greens support

- environmental policy changes will be supported;
- the Greens will be given three ministerial positions outside cabinet; and
- welfare payments will increase.

Upward pressure on interest rates . . .

On balance, the new policy mix will put some upward pressure on interest rates. The combination of increased demand for debt and more inflationary policy should have an impact at both the short and the long end of the curve – eventually. But we are talking at the margin, here, not an aggressive move.

In the longer run it's hard to know what all this means for the New Zealand Dollar but initially it will be, and has been, seen as a negative which, in turn, puts further upward pressure on rates. Uncertainty is the major factor here. Realistically, though, international developments will dominate.

Fears of currency manipulation overdone . . .

In the run up to the election, New Zealand First stated that it wanted to control the NZD using a Singaporean type model. We believe this is one policy that will not see the light of day so NZD investors should be less spooked than they appear to be.

There will be much discussion over ministerial positions but we do know that:

- Jacinda Ardern will be the Prime Minister;
- Winston Peters will have senior portfolios - he has been offered Deputy PM but hasn't yet decided whether to take it;

- Labour will keep the finance portfolio; and
- New Zealand First will have four ministers in cabinet

For businesses . . .

In the first instance, policy uncertainty will weigh on businesses as will policy change. Moreover, because we have no track record of seeing how such a grouping will behave in office and how stable it is questions will be asked about policy sustainability. Only time and observation will ultimately resolve this – one way or t'other.

For financial markets . . .

From financial markets and economic forecasters' perspectives the immediate questions that we would like answered are what will monetary policy look like (and we are sure any incoming Governor would like to know this too) and what will happen to the tax package that National had announced, which is now central to most forecasts.

For National . . .

For National, it's now a spell in opposition. Bill English has not confirmed what he will do but his performance in this campaign would likely mean that the job as leader is his if he wants it. The view is that he won't but we will just have to wait and see. National will be large and strong in opposition and will, undoubtedly, spend considerable time attempting to drive wedges between the component parts of the new Government.

For the economy . . .

Whatever the outcome of the above machinations, we restate our view that the New Zealand economy is on a fundamentally firm footing. We can say with some certainty that:

- the global economy will be supportive;
- fiscal policy will be stimulatory;
- monetary conditions will be stimulatory; and
- the terms of trade will help boost New Zealanders incomes.

We are not forecasting drought, aggressive monetary tightening or a global shock.

This being the case we maintain our view that the economy will continue to press on for the foreseeable future. Sure, short-term uncertainty may impact activity but it should be transitory in nature.

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