20 October 2017

NZD shocked by new government

- Some "sticker shock" to the formation of a new NZ government has seen a weaker NZD. While a near-term cloud overhangs the NZD from domestic political forces until we have more detail on policy and portfolios, we expect the negative impulse to quickly fade.
- In a long-term historical context, NZ's real exchange rate is high, but this can be easily explained by NZ's strong terms of trade. The call by some commentators that the NZD is over-valued in this context is a value judgment, but supporting evidence is scant.
- We re-estimate our short term NZD/USD model with new data and come out with unchanged conclusions. With fair value around 0.73, the NZD is a little oversold. But the softer GDT dairy auction this week reminded us why we have the NZD tracking towards 0.69-70 over the next 3-6 months. The hue of the government has no bearing on this, with global forces in charge.

At last, a new government is formed

The NZD has given an initial thumbs-down to the new Labour-NZ First-Greens government, representing "sticker-shock" to fresh uncertainty about the macroeconomic outlook. That is to be expected, but also represents an opportunity. Judged by the nudge down in NZ rates at the same time, the market's assessment is that the NZ growth outlook is much weaker as a result of the new government. We disagree and would push against that view until further notice.

No policy details have been announced and Ministerial portfolios have yet to be allocated. NZ First and the Greens will have disproportionate representation in the government, the former within Cabinet and the latter outside of Cabinet.

The lack of policy detail at this stage means that we are wary of jumping to conclusions for the market. Key on the agenda will be reductions in immigration (students, rather than skilled workers), modifications to the RBNZ Act (more cosmetic than real and unlikely to change much what drives RBNZ policy decisions), a greater-than-otherwise increase in the minimum wage, easier-than-otherwise fiscal policy, and a higher projected bond programme.

Importantly for the currency, what we do know is that NZ First's policy of adopting a Singapore-style managed exchange rate mechanism is a non-starter. That was always going to be the case, given the significant differences between NZ and Singapore, making such a managed exchange rate impractical.

Despite the lingering uncertainty about policy and positions, any further fall in the NZD is likely to be moderated to the extent that the result was half-expected and recent NZD underperformance over recent weeks reflected a reasonable chance of the outcome. Winston Peters' talk of fighting capitalism and his (and Labour's) more populist agenda don't sound market-friendly at face value, but the reality is that we'll likely see only a minor shift in economic direction.

A cloud will overhang the NZD until we get more policy detail over the coming week, but we'd expect the negative impulse from domestic political forces to quickly fade before more important global forces take over. Our currency forecasts can be considered under review until we get more policy detail, but we already had the NZD lower at 0.70 by year end and into the high 0.60s next year.

For sure we don't have a clean exchange rate story at present. Global forces – positive growth momentum, global commodity prices and high risk appetite – provide strong support for the NZD but ultimately are projected to fade. Domestic political forces have been negative for the NZD, but ultimately those should fade. The net result might well be a fairly steady exchange rate over coming months.

NZD is not over-valued in a long-term context

One of those urban myths out there is that the NZD is over-valued in a medium-long term context. It's a judgment that we've frequently fought against in our research. The RBNZ often runs this line, without supporting evidence, and we largely see its comments more as a tactical stance to encourage a lower NZD and higher inflation.

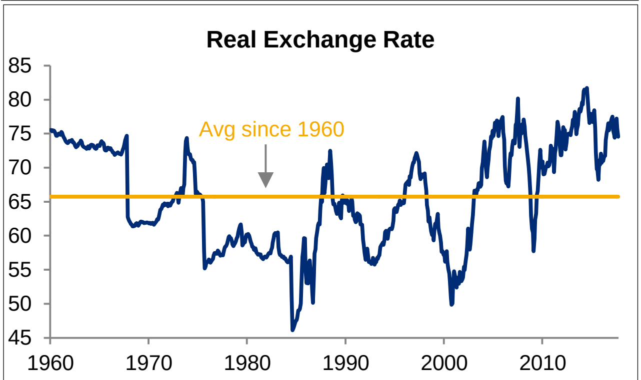
NZ First Leader Winston Peters is in favour of a weaker NZD. When asked last week if policies being discussed during coalition negotiations will keep the currency going down, Peters said "If you are an export-dependent nation why would you go ahead and persist with an inflated dollar when even the IMF says its over-valued? Why do you just ignore all the best advice in the world".

For the record, in its May 2017 Article IV report on NZ, the IMF said that the exchange rate was "moderately over-valued", based on the December 2016 NZD exchange rate. In Table 1 below we show the IMF's NZD real exchange rate assessment against its various models and provide a rough-and-ready estimate based on the current exchange rate.

The IMF's language of a moderately over-valued NZD back in December was based on model estimates ranging between 2 and 8%. Accounting for the fall in the NZ TWI since then, that range would drop to between -3 to 3%. In other words, if the IMF were to come out today with an assessment of the NZD, we think it would probably say that the real exchange rate was "fairly priced" on a medium-long term basis.

In our view there is a big difference between saying an exchange rate is "strong" or "high" and saying that it is "over-valued".

Yes, NZ's Real Exchange Rates is "High"



Source: RBNZ, BNZ

Table 1: IMF NZD real exchange rate models
% over/under valued

	@ Dec-16	@ Oct-17*
REER index regression	8%	3%
Current account regression	4%	-1%
External sustainability	2%	-3%

* BNZ estimate based on exchange rate movement since December
Source: IMF Article IV, BNZ

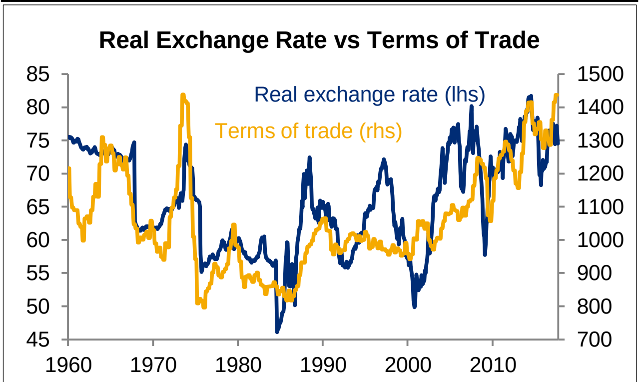
It is hard to deny the fact that the NZD is strong or high in a medium-long term context. The above chart shows the real NZD exchange rate back to 1960. NZ's real exchange rate has been above the long-term average for much of the past 15 years and the current real exchange rate is about 11% above that average. So yes, NZ does have a strong or high real exchange rate.

But is it over-valued? To us, to say it is over-valued would be passing a judgment that for some reason the strength of the NZD is inexplicable, not justified and causing significant harm to the economy – perhaps associated with a large and rising current account deficit, a deteriorating net international investment position, exporters crying out for help, and a hollowing out of NZ's export sector.

None of those factors have been in play for some time. NZ's current account deficit has been smaller than average for much of the past eight years, NZ's net international investment deficit is the lowest in over 20, maybe 30 years, and our frequent contact with exporters tells us they're generally doing well and are satisfied with the current level of the exchange rate.

It is instructive to overlay NZ's real exchange rate series with NZ's terms of trade. After all, NZ's commodity prices and terms of trade are a key factor that drives the NZD. The following chart shows the close link between NZ's real exchange rate and the terms of trade over the past 50 years or so.

Very Strong Terms of Trade Explains High NZD



Source: RBNZ, BNZ

Based on this single key variable, it is not hard to explain NZ's strong real exchange rate. NZ's terms of trade are near a record high (we have data back to 1860 showing this). To be sure, not all sectors of the economy welcome the strong exchange rate and we imagine there are pockets of exporters who are not exposed to higher commodity prices who are feeling the pinch. But overall, we see NZ better off with strong terms of trade and a strong exchange rate than if both of those variables were weak.

A weak exchange rate for NZ would normally be associated with some or all of: weak terms of trade, a weak domestic economy, or a weak global economy. Wishing for a lower NZD is akin to wishing export prices were much weaker or that the global economy headed towards recession.

If the NZD isn't particularly over-valued then attempts to drive it weaker will be futile. It is no surprise that the RBNZ's attempts to talk the NZD down over the years have been unsuccessful. On the day, the Bank can have an impact, but soon after fundamental forces come back in play.

NZD/USD Model Update

Recently CBA rebased and revamped its NZ commodity price index. This index feeds into our NZD short term fair value models.

We've taken the opportunity of this to re-estimate our NZD/USD model making the following changes (1) use the new CBA NZ commodity price index (2) extend the estimation period through to September 2017 (starting point remains 2004); (3) estimate the model using a real NZ-US rate spread for the entire period – we previously fudged the model and used real rates only over the more recent period.

So for the record, our model uses three key inputs:

(i) The CBA NZ commodity price index in USD terms.

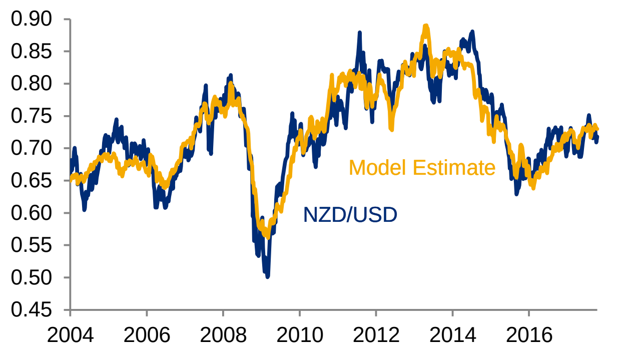
(ii) The BNZ risk appetite index.

(iii) Real NZ-US 1-year swap rate spread (using break-even 10-year inflation rates for the US and core CPI inflation for NZ averaging four Statistics NZ measures for this. Over the zero-lower bound period for US rates we adjust rate using Krippner's shadow US short rate).

The new model has a lower standard error than the previous model because real rate differentials work much better than nominal rate differentials when explaining currencies. The upward bias for the model estimate through 2017 has now largely disappeared, which means we no longer need to account for this bias when explaining the current estimate.

Current fair value on the updated model is USD0.73, which is the same level we noted in our Weekly on

NZD/USD Fairly Priced on Updated Model



Source: BNZ, Bloomberg

Monday (after accounting for the old model bias). So there is no change to our view that the NZD looks marginally over-sold at present, having not kept pace this year with the positive risk appetite backdrop.

However, another disappointing GDT dairy auction this week saw us revise down our projected milk payout this season from $6.75 to $6.30. We see downward pressure on dairy prices persisting over the near term, with EU stockpiles of skim milk overhanging the market, and dairy prices still look a bit stretched relative to international oil and grain prices.

Lower dairy prices support our view of the NZD heading to our year-end target of USD0.70 by year end, and being anchored around 0.69 through the first half of next year.

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