

Rapidly declining interest

RBNZ to cut OCR to 4.00% this month, 2.50% by mid-year

Welcome to 2009, a year that could have many people longing for the good old days of 2008. The New Zealand economy spent last year in a relatively mild recession, driven by domestic factors that are largely behind us. But this year, a severe global downturn and tougher access to credit promise to send the economy into a renewed downturn. New Zealand's woeful international debt position limits the scope for the government to borrow and spend in order to counter the effects of recession. So it's just as well that the RBNZ have plenty of room – more than any other major central bank – to deliver some relief on interest rates.

Towards the end of last year there were some moot questions around the economic outlook, namely: would NZ consumers save or spend their cash windfalls from lower petrol, interest rates and taxes; how severe would be the job correction in NZ; and how badly would be the contagion in our Asian trading partners? All of these questions are being resolved adversely for the near term economic outlook: households are saving, a third of firms are planning to reduce staff levels, and Asian exports are plummeting.

Recent data from here and elsewhere demonstrate how quickly the economic outlook has deteriorated. First, yesterday's *Quarterly Survey of Business Opinion* has put some hard numbers around the anecdotes of how much NZ businesses are struggling – and those numbers were extremely ugly. Own-activity expectations were by far the lowest in the history of the survey, raising the risk that at least one upcoming quarterly GDP read will be an absolute shocker. Firms have indicated that they plan to ride out the slowdown by delaying investment and shedding staff – steps that are prudent at the individual level, but en masse will add to the downturn in domestic demand.

Second, recent international data confirm that since around August last year, the rest of the world has joined the US in recession. Industrial activity and export demand have contracted at an astonishing pace in the last few months, particularly among the developing economies. Prospects for a second-half

recovery in growth this year look dim – to the extent that there is any rebound in activity in H2, it is likely to be in the context of a steep plunge in H1.

We will be publishing our full set of forecasts in the *Economic Overview* later this month, but it is clear that the overall picture justifies a much lower path for interest rates. **We now expect the OCR to be cut to 2.50% by the middle of this year (previously 4.00%).** This would be far lower than the cash rate has ever been in recent history, reflecting the extent of the downside pressures that the New Zealand economy faces.

With fuel prices falling, and more spare capacity opening up in the domestic economy, inflation is completely off the radar for the near term. By cutting rates too little, the RBNZ risks a deeper downturn than necessary and an undershoot of their inflation target. On the other side, the risk is not in cutting rates too far, but in keeping them low for too long – an issue that all central banks will have to grapple with once the global economy does start to recover.

With the RBNZ likely to continue to front-load their easings, **we expect a 100bp cut at the 29 January review (previously 50bp).** An even larger move shouldn't be ruled out, though with the decision just two weeks away, there's limited scope for new information that could conclusively sway the RBNZ in that direction. We are also pencilling in another 100bp cut in March and 50bp in April, to bring the OCR to the endpoint of 2.50%.

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