

Doing the interest rate limbo

January 29 OCR Preview: RBNZ expected to cut 150bps to 3.50%

- **Economic conditions have deteriorated further since December. The world is heading for the worst recession in decades, and New Zealand will remain in recession for several more quarters.**
- **We expect the OCR to be reduced to a record low of 2.50% this year, starting with a 150bp cut next week.**

Economic conditions have changed at an astonishing pace since the last *Monetary Policy Statement* in December (a phrase that is becoming depressingly familiar). At the time, the RBNZ projected that the 90-day rate would fall to 5.1% – and by delivering a massive 150bp cut on the day, they ensured that they would reach that end-point quickly. But the continuing deterioration in the global economy suggests that the RBNZ has a lot more work to do from here.

The main developments since December are:

Weaker world growth: Consensus Forecasts have been slashed further in recent months. The November forecasts (which the RBNZ used in the December *MPS*) suggested that the world was a facing a recession comparable to the early 1980s, when global growth slowed to 0.9%. The latest set of forecasts implies something much worse: our main trading partners are now expected to contract by 0.1% this year, with North America, Europe and Japan each shrinking by 1.5% or more.

Weaker near-term GDP outlook: In December, the RBNZ shared our view at the time that the contraction in the New Zealand economy would be limited to the first three quarters of 2008 (though growth would remain sub-par for a while longer than that). More recent data, in particular the latest *Quarterly Survey of Business Opinion*, has put paid to that hope. Firms' own-activity expectations were by far the lowest in the history of the survey, and investment and hiring intentions have plunged. We now expect several more quarters of negative GDP growth, with the steepest drop coming in Q4 2008.

Lower capacity utilisation: The *QSBO* also found that capacity

utilisation fell to 88.8%, the lowest rate since 1999. There is now a significant amount of slack opening up in the economy, which will ease the persistent domestically-generated inflation that has long frustrated the RBNZ (annual non-tradeables inflation has averaged 4.1% in the last five years). The outlook for lower inflation over the medium term gives the green light for further rate cuts.

Weaker commodity prices: The outlook for prices of New Zealand's key commodity exports has deteriorated further. The re-introduction of subsidies for dairy products in Europe, and possibly in the US, is an ominous development.

Credit markets tight: Raising funds offshore remains costly, and will continue to dampen the extent of pass-through from policy rates to retail lending rates. Ironically, the introduction of government guarantees for wholesale funding has helped to bring this issue to light: as Australasian banks regain access to offshore funding markets, the true cost of borrowing is starting to be revealed (with a hefty fee for the government guarantee added on top).

So how low will rates need to go? We estimate that these developments together are worth as much as 200 basis points off the 90-day rate in the RBNZ's forecasting model. That implies a new low point of around 3%, which is in line with our forecast of an OCR of 2.50% by mid-year (see our 14 Jan Bulletin "*Rapidly declining interest*").

A cash rate of 2.50% would be astoundingly low relative to New Zealand's history. But the severity of the global recession and the credit crisis means that the usual benchmarks for monetary policy are out the window. Many developed economies will face zero or near-zero policy rates by the end of this year; the US has already reached that point and is now looking to drive down longer-term market rates by buying bonds and asset-backed securities directly. In this environment, an OCR of 2.50% wouldn't look at all outlandish.

The remaining question is how the RBNZ chooses to deliver that easing. So far, Governor Bollard has favoured cutting rates

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early and decisively. If the RBNZ shares our view that there is another 250bp of easing to go, a 100bp cut at next week's review would be the minimum. The case for an even larger move is finely balanced, but we think that the weak *QSB0* and the downgrades to world growth forecasts argue for a 150bp cut. It's not just the weaker outlook, but the *certainty* that things are getting worse, that argues for the RBNZ to move quickly.

Market implications

Interest rate markets are currently pricing 110bp of easing for next Thursday. Swap rates have fallen sharply in recent weeks, and some of this has already been passed on to retail mortgage rates ahead of the OCR decision – floating rates have been cut by around 75bp, while two-year fixed rates are down a more modest 20bp. A 150bp cut would be needed to push wholesale rates lower on the day, thereby putting the acid on lenders to pass on further mortgage rate cuts.

With a 150bp cut, we would expect the statement to leave the door open for further easing, but to be noncommittal about the size of future moves, in order to hose down expectations of another jumbo-sized move at the March *MPS*. For now, we are pencilling in a 50bp cut in March, but after next week's review we'll be back to world-watching.

In recent months, currency markets have tended to favour proactive central banks more so than wide yield spreads, so a 150bp cut would probably benefit the NZD more than a 100bp move. However, jittery investors and the perceived safe-haven appeal of the US dollar will tend to dictate the trend in the NZD over coming weeks.

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