

Can't stop, won't stop

RBNZ March MPS Preview: a 100bp OCR cut – but maybe less

- A further deterioration in the global economy has put the RBNZ on track for an OCR of 2% in coming months.
- So far the RBNZ has favoured delivering most of the expected easing up front, and with good reason. We expect another 100bp next week.
- However, there is a strong risk that they decide to keep something in reserve for later in the year, as the RBA did earlier this week.

The RBNZ delivers its latest *Monetary Policy Statement* next Thursday, in the midst of a deteriorating world economy, plunging share markets, mounting job losses, and extreme measures to revitalise the global financial system. In other words, just another day at the office.

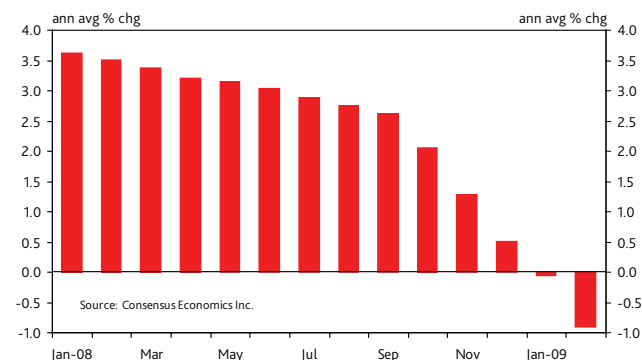
We think the RBNZ has a lot more easing to do, and we're inclined to think that they will favour another jumbo-sized move next week, so that they can get interest rates down quickly and commit to keeping them there. But there's a good chance that they decide to take a leaf out of the RBA's book and hold back some of their firepower for future reviews.

As usual, we start by reviewing what has changed since the last OCR review in January. While the RBNZ didn't publish a set of forecasts, we estimated at the time that they would have been eyeing a low point in the OCR of 3%. The main developments since then suggest that the terminal point will now be even lower:

Weaker world growth: Consensus Forecasts for global growth were slashed even further in February. New Zealand's major trading partners are now expected to contract by 0.9% in this calendar year, followed by growth of just 2.2% next year. The largest downgrades were for Australia and Asia, which until recently were seen as the last bastions of resistance against the global downturn. We estimate that these latest downgrades would lower the RBNZ's interest rate projections by another 50 basis points, relative to what they had in mind in January.

Moreover, there is no sign that the pace of revisions is slowing – this was the fifth straight month where trading partner growth forecasts for 2009 were cut by 0.6% or more. These forecasts are known to be serially correlated – that is, downgrades tend to be followed by more downgrades – so it's unlikely that expectations for world growth have reached their nadir just yet.

Figure 1: 2009 trading partner growth forecast



Lower inflation expectations: The latest RBNZ survey of inflation expectations two years ahead fell from 2.7% to 2.3%, as businesses anticipated that the weaker economy would ease domestic inflation pressures. This is a far cry from the record high of 3.0% recorded just six months ago. The RBNZ's forecasting model assumes a strong degree of stickiness in inflation expectations, so the speed of this decline will be a 'surprise' at least in a mechanical sense – we estimate it will shave another 40 basis points off their interest rate track.

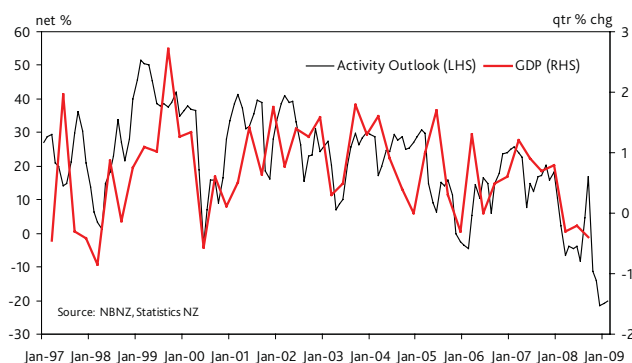
Business confidence: The most recent business confidence survey was extremely poor, with own-activity expectations remaining close to all-time lows, and key indicators of activity such as employment and investment intentions falling to new lows. While not strictly an input to the RBNZ's forecasts, the fact that businesses are still sharply reining in their ambitions, despite the steep falls in interest rates and the exchange rate so far, doesn't bode well for growth in the near term.

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Figure 2: NBNZ Business Confidence and GDP



Employment: The December quarter employment figures provided mixed messages: the unemployment rate rose from 4.2% to 4.6% as expected, but at the same time the number of people in work apparently rose by 0.9%, against widespread expectations of a decline. We suspect that the RBNZ will be sceptical as to whether the latter number is genuine – the employment figures have been notoriously choppy in the last couple of years – but they won't know for sure until the next report is published in May. On balance, we don't think the employment data will be a factor in slowing the pace of easing.

Putting all of this together, we think that the 90-day rate projection in the March MPS could reach as low as 2.4%. That would be broadly in line with an OCR of 2% by the end of this easing cycle.

Tac tic toe

The current cash rate of 3.50% is still a long way from that end-point, so the next question is one of tactics: how the RBNZ chooses to get there. Over the last several reviews, they've been content to deliver most of the expected easing in one hit, regularly beating market expectations of the size of the cuts. It's not just the depth of the downturn, but the high degree of certainty about which direction the economy is heading, that has given them the confidence to move quickly.

However, it's significant that the Reserve Bank of Australia chose to leave their cash rate on hold at 3.25% this week, despite the appalling outlook for the global economy and growing signs of weakness at home. We have to emphasise that this appears to be a tactical move, with the statement noting that "the stance of monetary policy was appropriate *for the moment*". Australia has been fairly resilient so far in the face of the global contraction, but times are expected to get much tougher from here – any lingering doubt will have been dispelled by the shocking 0.5% fall in December quarter GDP, revealed just a day after the RBA's decision. But by holding back on rate cuts today, the RBA can be seen to be responding to the slowing economy as it becomes more apparent through 2009. We still expect the RBA to cut to 2% over this year.

In January the RBNZ stated that "we would expect any further reductions to be smaller than those seen recently". This is nothing new – central banks around the world have been hoping to slow the pace of easing for the last year, only to be overtaken

by events. Nevertheless, the temptation must be there to follow the RBA's example and hold back some firepower this time. We would still plead the case for another jumbo-sized cut, as the RBNZ faces some very different conditions to the RBA:

- Notwithstanding the surprise fall in Q4 GDP, it is true that Australia has not experienced the same sort of contraction as the major industrial economies. In contrast, New Zealand was in recession for the whole of 2008, and the outlook for the first half of this year isn't too healthy either. There's no obvious case for holding back rate cuts until the bad news arrives – it's already here.
- Australia has seen much more 'new' fiscal stimulus, with the government unveiling an A\$42bn stimulus package last month (on top of an A\$10.8bn package late last year). New Zealand's fiscal position is expected to add a hefty \$7bn to the economy in this fiscal year, but this contribution has been known for some time.
- The RBNZ gets less immediate traction from rate cuts, due to the greater prevalence of fixed-rate mortgages in New Zealand. But on the plus side, borrowers will be rolling on to lower rates for years after the OCR itself bottoms out. There is no need for the RBNZ to draw out the easing cycle for longer – the market naturally does it for them.

Ultimately, though, it comes down to the RBNZ's preferred tactics. So while we are sticking with our existing forecast of a 100bp cut next week, we have to accept that smaller moves of 75 or 50 basis points are equally likely. We doubt that a no-change is on the table – it's hard to imagine that Dr Bollard would spend so much time urging lenders to pass on interest rate cuts, then give them nothing to pass on.

Market implications

We are firmly of the view that the RBNZ will aim to get the OCR down to 2% over the next few months. A cut of less than 100bp next week, to the extent that it was a tactical decision, would not change our view on this. At the moment we have another 50bp cut pencilled in for April, but as always this will depend on how the upcoming data pans out.

Interest rate markets are pricing about 65bp of easing for next week's review; this has been scaled back from 80bp prior to the RBA announcement. That leaves the door open for the RBNZ to cut by only 75bp and still 'surprise' the market enough to push wholesale rates lower. The impact of the rate cut is more likely to be felt in short-term rates – the current vogue for yield curve steepening trades, in a thin market, is having the unfortunate side effect of pushing longer-term rates higher.

A larger rate cut would be more of a negative for the New Zealand dollar. Earlier in this cycle, the market tended to reward currencies where central banks were being proactive; but as it has become clear that policy makers can do little to avoid a severe slowdown, the focus has shifted back to more standard measures such as relative economic growth and yield spreads.

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