12 March 2009

Little helpers

RBNZ March *Monetary Policy Statement*: OCR cut by 50bp to 3.00%

- **The RBNZ cut the OCR by less than the market was anticipating, and signalled that any further cuts will be on a much smaller scale.**
- **The RBNZ is looking to fiscal stimulus and a further decline in the exchange rate to drive a strong recovery in growth from the second half of this year. The risk is that neither of these deliver as hoped and that interest rates have to do more of the work.**
- **We continue to expect the OCR to fall to 2.00% by the middle of this year.**

Today the RBNZ cut the cash rate by 50 basis points to 3%, a change in tack towards a slower pace of easing after delivering cuts of 150bp at each of the last two reviews. We had expected a 100bp cut this time, while interest rate markets were factoring in about 70bp of easing before the announcement. A change of pace was inevitable at some point, given that interest rates are now reaching very stimulatory levels; but with the global economy deteriorating at a rapid rate, we weren't convinced that it was time to slow down just yet.

The RBNZ's latest 90-day rate projection bottoms out at 3.0% *(Figure 1)*, which is roughly consistent with an OCR of 2.5%. Given the new information since their last published forecasts – in particular, the sharp downward revisions to Consensus forecasts for world growth – we had estimated a low point for the 90-day rate of 2.5%, which would have justified a 100bp cut today. So we were surprised by the RBNZ's relatively shallow projection for further easing – and even more so given that their own forecasts for world growth are even worse than Consensus, with New Zealand's trading partners expected to shrink by 1.8% this calendar year *(Figure 2).*

While the RBNZ were pessimistic on the rest of the world, they were surprisingly cheery on New Zealand's growth prospects beyond the current downturn. GDP is forecast to shrink further in the first half of this year, but to recover rapidly from there on, with 4.5% growth in calendar 2010 and 4.1% in 2011. GDP is expected to rise by 2% in the second half of this year alone – a literal V-shaped recovery. RBNZ Governor Bollard

Figure 1: 90-day rate projections

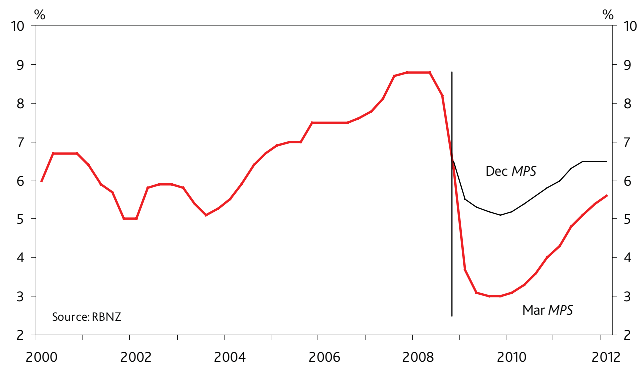
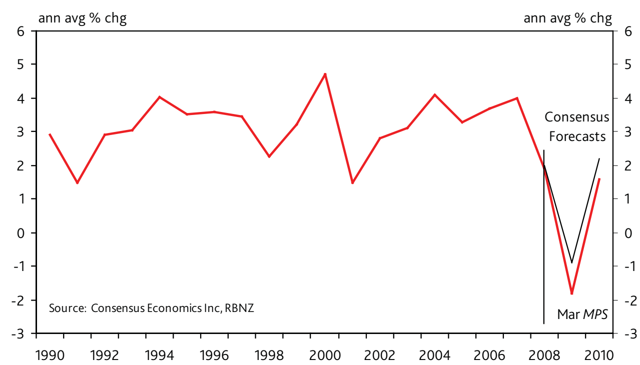


Figure 2: Trading partner weighted average GDP growth



acknowledged that the risks around their forecasts are largely to the downside, and if the recovery is delayed then an OCR of 2% is still on the cards.

The interesting question is where the growth will come from. Households are expected to save a greater share of their income, to shore up their balance sheets; construction is expected to fall further, reflecting the housing market downturn; businesses have pared back their expansion plans; and export sectors – especially tourism – are expected to struggle in the face of weak world demand.

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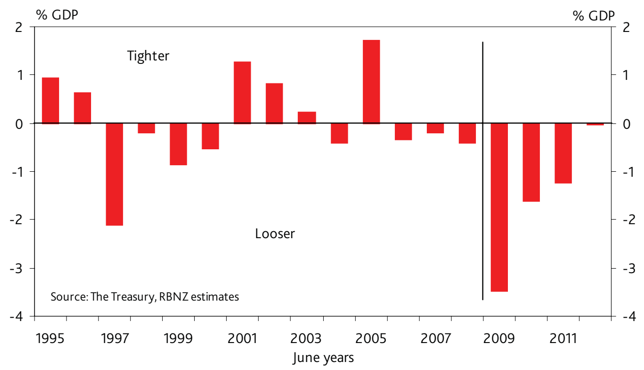
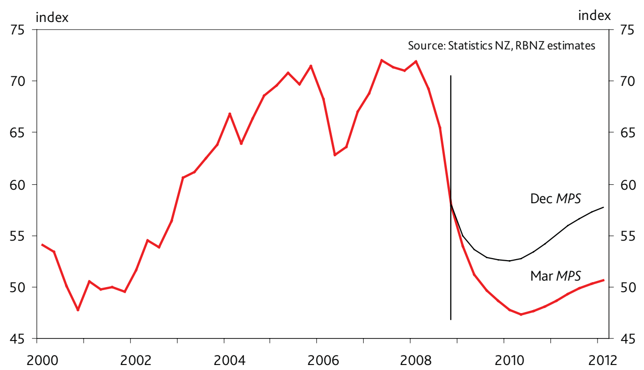
So what does that leave? The government. To be fair, the contribution of government shouldn't be downplayed. Even without the kind of flashy stimulus package seen in other countries, the fiscal impulse is projected to add 3.5% to GDP in the year to June 2009 and another 1.6% for June 2010 *(Figure 3)*. But the obvious risk to the RBNZ's growth forecasts is that fiscal stimulus is neither as quick nor as effective in offsetting the broad-based weakness in the private sector.

Figure 3: Fiscal impulse



Another noteworthy point is the RBNZ's exchange rate projections. The trade-weighted index is expected to fall to around 47 – matching the all-time low in late 2000 – and to remain well below average levels for several years to come *(Figure 4)*. The RBNZ see this as a necessary part of the economy's adjustment, by improving exporters' competitiveness and making New Zealand dollar assets cheap enough to attract foreign investors.

Figure 4: Nominal TWI assumption



We broadly agree with their forecast, and the reasoning behind it. But this clearly goes beyond the RBNZ's usual 'technical assumption' for the exchange rate – this is a statement about the overall policy stance that they require. In other words, they are counting on the currency to do more of the easing for them. The risk is that if the NZD doesn't behave as they would like – and currencies are not known for bowing to the wishes of central banks – then the burden will fall back on to interest rates.

Looking ahead, the RBNZ's interest rate projections leave room for another 50bp of cuts, though with risks to the downside for their growth forecasts, a further cut to 2% is possible. They point out that there is a lot of bad news still to come, which they have anticipated and factored in to previous policy decisions – for example, as one of the most lagging aspects of the economy, unemployment is likely to keep rising for some time to come. As such, the appropriate point at which to end the easing cycle is not when the economy starts to recover, but when it stops falling short of (very weak) expectations. Unfortunately, it's not at all clear that we have reached that point yet.

The RBNZ seem concerned about the implications of taking the cash rate below 2%. Their press release noted that "New Zealand needs to retain competitiveness in the international capital markets", implying that policy rates among New Zealand's peers (specifically Australia) may be a constraint on the OCR. However, our discussions with RBNZ analysts suggest that they see this as more of an issue for the longer term – for now, if the size of the shock facing the New Zealand economy warrants having a temporarily lower cash rate than Australia, then so be it.

In any case, the question is not whether the RBNZ could take the cash rate below the Australian level, but whether they would get any traction on longer-term interest rates – the problem that has plagued the US and the UK through much of this easing cycle. The OCR is a risk-free overnight rate; it has an influence on longer-term lending rates, but ultimately they are determined by the market. If investors genuinely demand a premium for lending to New Zealand then they will charge one, regardless of where the OCR lies. Bear in mind that this premium could also manifest itself through a lower NZ dollar, an avenue that the RBNZ would probably prefer.

Market implications

The 50bp cut was less than the market was anticipating. Wholesale interest rates rose sharply in response, though they have been pegged back over the day as the market has accepted that further rate cuts are still on the way. The 90-day bank bill rate has risen by 24bp to 3.36%, while the two-year swap rate is 12bp higher at 3.33%. Higher wholesale rates mean little scope for lower retail rates on the back of today's announcement. NZD/USD rose by half a cent to 0.5120.

We are sticking with our view that the OCR will reach 2% by the middle of this year. While the RBNZ has stressed that any future cuts will be smaller than in recent history, the pace of easing will ultimately be dictated by how the domestic economic data pans out. Upcoming releases such as the *Quarterly Survey of Business Opinion*, retail spending and unemployment are unlikely to support the story of a rapid second-half recovery in growth. We also expect the RBA to cut to 2% over coming months, so relative interest rates shouldn't be a constraint to further cuts. We expect further cuts of 50bp each in the April and June reviews.

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***Monetary Policy Statement* March 2009 – Policy Assessment**

The Reserve Bank today reduced the Official Cash Rate (OCR) by 50 basis points to 3 percent.

Reserve Bank Governor Alan Bollard said: "The world economy deteriorated very rapidly late last year, amid ongoing losses and extreme volatility in international financial markets. While monetary and fiscal policy responses in many countries have been substantial we still expect the adverse economic forces generated by the crisis to remain dominant throughout 2009. The timing and extent of global recovery remain highly uncertain.

"In New Zealand, the impact of difficult trading conditions is showing through clearly in reduced export revenues, weak business sentiment, and sharply curtailed investment and employment. Further house price falls and increased precautionary saving by households are driving a weakness in spending. Inflation pressure is abating rapidly as a result.

"The OCR has now been reduced 525 basis points in little more than six months, taking interest rates to very stimulatory levels. Further falls in the lending rates faced by households and businesses are in the pipeline. While credit growth is easing in line with the weak economy, we expect financial institutions to continue lending on sound business propositions, to support the recovery.

"In addition to the substantial change in monetary policy settings, there has been a large amount of stimulus from fiscal policy. These policy changes, together with the sizeable exchange rate depreciation, will act to support the New Zealand economy: therefore, we expect to see activity troughing in the middle of this year and then gradually picking up thereafter. However, the scale of the global financial crisis is such that there is great uncertainty about future economic developments and there is a risk that the recovery may occur later and be more protracted than we anticipate.

"As economic activity troughs, we expect the rapid easing of monetary policy to slow. Any future cuts will be much smaller than observed recently. We do not expect to see in New Zealand the near-zero policy rates of some countries. New Zealand needs to retain competitiveness in the international capital markets. We will assess the need for further cuts in the OCR against emerging developments in the global and domestic economies and the responses to policy changes already in place."