Cut to the quick

January 29 OCR review: RBNZ cuts by 150bp

- **The RBNZ reduced the cash rate by 150 basis points to a record low of 3.50%, citing the mounting global recession.**
- **The RBNZ continues to favour reaching its intended end-point quickly. We expect further cuts in coming months, to a low at this stage of 2.50%.**

The Reserve Bank cut the cash rate by a further 150 basis points to 3.50%, in line with our expectation. The majority of analysts were picking a 100bp move, with interest rate markets splitting the difference.

The RBNZ has received at least as much unwelcome news on the economy since the December *Monetary Policy Statement* as it did between the October and December reviews. Forecasts for global growth have been slashed at an unprecedented pace. New Zealand's main trading partners are expected to contract by 0.1% this year, compared to forecasts of 1.3% growth at the time of the December *MPS*, and we expect this will be downgraded even further as forecasters come to grips with the idea that Australia won't avoid recession this year. RBNZ Governor Bollard was accurate in describing this as "worse than anything we have seen since World War II".

Closer to home, the near-term outlook for activity is substantially worse. In December, the RBNZ shared our view at the time that negative GDP growth would be limited to the first three quarters of 2008 (though growth would remain sub-par for a while longer than that). But recent business surveys have been extremely weak – firms are shoring up their own prospects by delaying investments and shedding staff. Meanwhile, it's becoming clear that much of the extra cash hitting consumers' pockets from cheaper fuel, lower interest rates and tax cuts is staying there. We now expect Q4 GDP to mark the deepest point of the recession, with a 0.9% decline.

And if the RBNZ needed any more reason to deliver a large cut, this week also saw another significant drop in Fonterra's dairy payout forecast to $5.10/kg for this season. Even allowing for a recovery in production from last year's drought, this still means around $3bn less in dairy farmers' pockets compared to last season.

The statement noted that further rate cuts would likely be smaller and dependent on events. We see this more as a reflection of the fact that the RBNZ favours delivering most of the expected easing up-front – we think that they have an end-point in mind of around 3% for 90-day rates (compared to 5% in the December *MPS*), and today's cut gets them much of the way there. We don't think they're at all concerned about running out of room to ease – zero rates are still are a long way away. Bear in mind that many developed countries *started* their easing cycles from rates closer to 4-5%. Nor do we put any credence on the idea that the RBNZ can't afford to lower interest rates further for fear of scaring off foreign funding. With many major economies heading to zero or near-zero interest rates this year, New Zealand's interest rates will still be attractive even at lower levels from here.

Market implications

The 150bp cut was larger than the market was anticipating. NZD/USD fell nearly a cent to 0.5210 before recovering to 0.5250. The two-year swap rate has fallen by more than 20bp to a new record low of 3.26%.

Today's decision was entirely in line with our view that the RBNZ will reduce the OCR to 2.50% this year, and that they will get there quickly. Given that end-point, we think that 50bp is in the bag for the March *MPS*, and any further bad news on the global economy will increase the odds of a larger move.

RBNZ press release

The Reserve Bank today reduced the Official Cash Rate (OCR) from 5.0 percent to 3.5 percent.

Reserve Bank Governor Alan Bollard commented that "the news coming from our trading partners is very negative. The global economy is now in recession and the outlook for international growth has been marked down considerably since our December *Monetary Policy Statement*.

"Globally, there has been considerable policy stimulus put in place and we expect this to help bring about a recovery in growth over time. However, there remains huge uncertainty about the timing and strength of a recovery.

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"The extent of the decline in global growth prospects and the ongoing uncertainty has played a large part in today's decision. We now expect the impact on New Zealand of these developments to be greater than we did in December, as a result of a more negative outlook for the terms of trade and exports, and tighter credit conditions.

"Inflation pressures are abating. We have confidence that annual inflation will be comfortably inside the target band of 1 to 3 percent over the medium term.

"Given this backdrop it is appropriate to take the OCR to a more stimulatory position and to deliver this reduction quickly.

"Today's decision brings the cumulative reduction in the OCR since July 2008 to 4.75 percentage points. Lower interest rates will have a positive impact on growth, alongside a lower exchange rate and fiscal stimulus, provided firms and households do not unnecessarily contract their spending.

"To ensure the response we are seeking, we expect financial institutions to play their part in the economic adjustment process by passing on lower wholesale interest rates to their customers. This will help New Zealand respond flexibly.

"Further movements in the OCR will be assessed against emerging developments in the global and domestic economies and the response to policy changes already in place. We would expect any further reductions to be smaller than those seen recently."

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