

The case for cutting

March MPS Preview: A 50bp OCR cut to backstop confidence

- **We expect the RBNZ to cut the cash rate by 50bps to 2.50% next week.**
- **The devastating earthquake in Christchurch will dramatically alter the near-term outlook for growth; the knock-on effects to confidence and activity are unquantifiable.**
- **Much of the harm cannot be undone, but the RBNZ can at least act to shore up confidence and ease the burden on an economy whose short-term growth prospects have been stunted.**

Like the rest of the country, the RBNZ's thoughts as it prepares next Thursday's Monetary Policy Statement will be dominated by the devastating earthquake in Christchurch on 22 February. At this early stage it's impossible to gauge the full economic and social impact, though it will clearly be some multiple of what was estimated for last September's quake. That uncertainty in itself presents a sizeable risk to the economy's near-term prospects, and not just within the Canterbury region. Our judgement is that the RBNZ will err on the side of shoring up confidence and easing some of the short-term pain, with a 50 basis point cut in the OCR next week.

Our call is less controversial now than when we made it a week ago, with a majority of analysts now expecting a cut of some size. Even so, we should spend a bit of time explaining the ins and outs of what will undoubtedly be a tough decision. And we should emphasise up front that this is not a claim about what the RBNZ 'should' do; the right response will become clear only in hindsight. Our pick is merely a reflection of what we would do in the same situation, given the balance of risks and our understanding of the monetary policy framework.

Why cut?

As was discussed in September, earthquakes tend to be ultimately inflationary. Over the medium-term horizon in which the RBNZ operates, repairs and reconstruction will lift the level of activity above where it would otherwise have been, soaking up some of the excess capacity that would have kept inflation pressures subdued. On balance, a major earthquake may require a steeper interest rate track over the medium term.

But that balance also requires a central bank to look through the near-term costs of disrupted activity. The RBNZ was able to do so in September, but the impact will clearly be much deeper and longer-lasting this time around. Indeed, this quake is doubly damaging to the near-term growth outlook, because much of the growth expected for the first half of this year related to reconstruction work from the September quake. And the disruption to activity won't be confined to Canterbury. Many New Zealand businesses have direct and indirect links to the region, and purchasing or investment decisions may be put off until the situation becomes clearer.

Our pick for a rate cut is not a comment on the state of the economy before the earthquake. The RBNZ had already recognised that activity was weak in the second half of 2010; whether it met the technical definition of a 'double dip' recession is a moot point (we've already seen that the economy shrank on a per capita basis in the June and September quarters). But there was a growing body of anecdotes and survey data that suggested the economy was regathering a head of steam in the early part of this year. The question now is how much if any of that momentum will be sustained.

What would cutting rates achieve?

The earthquake has caused much harm that cannot be undone by lowering interest rates. What the RBNZ can do, however, is to mitigate the potential flow-on effects to the wider economy via disrupted activity and the likely hit to confidence. The OCR is a blunt instrument, but that's also what makes it so effective in an emergency.

While the need to shore up confidence is a key part of the case for a rate cut, we're not proposing it simply as a symbolic gesture; there would still have to be a tangible benefit to the economy. We're seeing that already: lower wholesale interest rates, in anticipation of an OCR cut, have been passed through to some lending rates. Of course, for those lower market rates to be sustained, the RBNZ will still have to deliver.

Not everyone is convinced that lower interest rates would provide any benefit, or that they are the right tool for the job. We'd simply note that even those arguing against a rate cut are in agreement that the RBNZ should further delay the

For further information, questions or comments contact Brendan O'Donovan, telephone (04) 470 8250, email brendan_odonovan@westpac.co.nz

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resumption of rate hikes. Let's think about what this would achieve: signalling a slower pace of tightening would push down the short end of the yield curve, just as an OCR cut would. So there's no real disagreement about whether rates should be lower, just about how much.

Why cut by 50bp?

This is admittedly the most uncertain part of our call; if cutting rates is intended as a morale booster, does the size matter? With immeasurably large risks to the downside, we think it better to err on the side of 'insurance'. Once an easing proves to be no longer necessary, it can be withdrawn fairly quickly – admittedly not without cost, since it would add to inflation pressures in the meantime. Our forecasts now imply that once rate hikes resume (in early 2012), the pace of tightening will be a little faster than previously, and given the greater extent of reconstruction activity that we'll see in 2012 and beyond, the OCR is more likely to peak on the tight side of neutral, rather than settling at neutral as the RBNZ had been aiming for.

Projections

Unlike last September, the RBNZ would have had just enough time to incorporate the earthquake into its MPS projections – though like our own forecasts, these could only be considered working assumptions at best. The main details are likely to be:

- Close to zero growth in the first half of this year, picking up in the second half as reconstruction resumes. Growth to slow to around 1% for calendar 2011 (no better than population growth), but then to accelerate beyond the 3.8% peak that was previously projected for mid-2012.
- Higher unemployment, lower business investment and construction over the near term.
- Underlying inflation (excluding government policy changes) well within the 1-3% target range for the next two years.
- A lower interest rate track over the next two years. To the extent that tighter policy is required in the future, it may be pushed out beyond the published forecast horizon.

Market implications

A recent poll showed 13 out of 19 analysts expecting a cut next week, with nine of them plumping for a 50bp move. Interest rate markets have priced in 35 basis points of easing, suggesting a similar split of opinions. And the fall in the NZ dollar over the last week, most notably to a 19-year low against the Australian dollar, also reflects anticipation of a sizeable rate cut.

That might make it seem that the RBNZ is now obligated to deliver a 50bp cut – anything less might send interest rates and the currency higher again. But that shouldn't really be a concern; the RBNZ should aim for whatever level of interest rates that it thinks is appropriate. And in fact, there may not be much left to squeeze out of the market even in the event of a 50bp cut. The two-year swap rate has already fallen by 50bps since the quake; even we're not suggesting that an insurance cut would need to stay in place for that long.

Brendan O'Donovan, Chief Economist, Ph: (64-4) 470 8250

Michael Gordon, Markets Economist, Ph: (64-4) 381 1412