

RBNZ September *Monetary Policy Statement* Review

Key points

- > The OCR was cut by 50bps to 7.50 percent, against expectations of a 25bp cut.
- > The policy assessment was dovish, with growth concerns weighing. Inflation is of secondary importance, for now.
- > The RBNZ are front loading the easing cycle, and while a welcome response, this is not a risk-free strategy to pursue.
- > Recent developments around the globe, and also credit markets, have been critical in the Bank's assessment.
- > We remain comfortable calling the cash rate to 7 percent and then pausing, but this is contingent on the global scene not worsening further, which looks to be the key risk.
- > The market will now seriously think about 50bps for October, although we remain comfortable calling 25bp.

Assessment

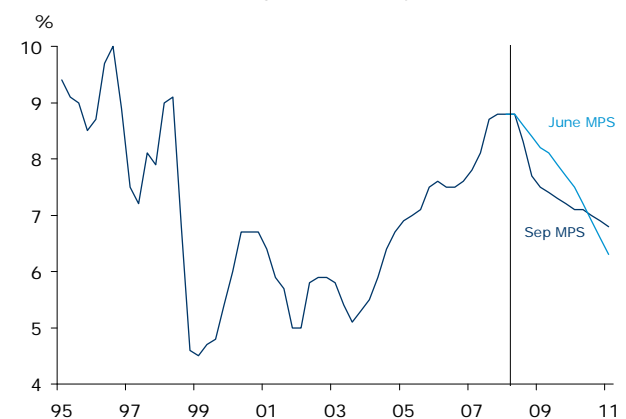
The RBNZ cut the OCR to 7.50 percent. In a surprise move, the RBNZ cut the OCR by 50bps to 7.50 percent today. The Bank was quite stark in their assessment about the downside risks to growth, and although near-term inflation is still projected to increase to 4.9 percent this quarter, that is of secondary importance for the time being. *"At this time, we believe it is appropriate to lend more weight to the downside risks associated with the deteriorating global outlook, increased credit pressures, and domestic housing market correction. However, we remain mindful of the risks to inflation."*

Global growth and credit developments were key to the aggressive move. Anyone who has travelled through the US of late (our Chief Economist has been twice) has generally come back relatively uneasy over prospects. We suspect the same applies at the RBNZ, and recent developments like Fannie Mae, Freddie Mac, and rumours of another major investment bank in difficulty bear this out. Remember, this kind of financial instability – being credit – highlights NZ's Achilles heel, namely a huge current account deficit. Moreover, the Bank has stepped aside from their usual practice of using *Consensus* forecasts for their global growth projections as they believe they *"do not fully reflect the downside risks to the outlook for 2009."* The RBNZ have pulled down their global growth projections and also see downside risks, particularly from Asia. The recent sharp downgrading of the outlook for Australia and notable change of tone and action from the RBA is also likely to have had a key influence. But it is

also credit market developments and some frustration that interest rate relief was not flowing through already, with fixed mortgages (and lending rates to businesses) being kept high by offshore credit costs, that has seen the Bank act more aggressively than expected. By "surprising" the market today with a larger move they get immediate monetary relief into the economy.

Today's decision was all about front-loading the easing cycle. Interest rates are still forecast to get back to roughly the same level flagged in June (6.9 percent) by the end of 2010, but at a faster rate. The Bank views this as appropriate *"in light of the tightness of current credit conditions and the time it will take to affect the actual interest rates faced by households and businesses."* In other words, the RBNZ view that the economy needs assistance right now, and believes that a 50bp cut is appropriate, as they still don't expect this to be fully passed on given the backdrop of a challenging credit environment.

RBNZ 90-day bank bill projections



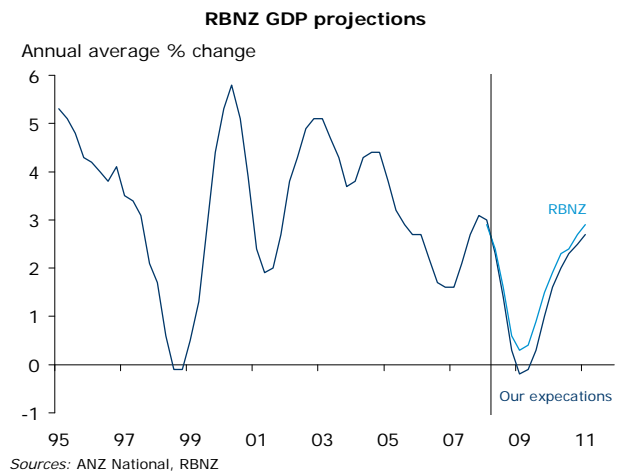
Sources: ANZ National, RBNZ

In terms of today's decision, it appears some guidance was implicitly being given in a recent bulletin article, which looked at the interaction between monetary policy and financial stability. The RBNZ takes distinct actions in order to pursue its goals of monetary and financial stability. However, they still need a degree of coordination between the two areas. *"Inappropriate monetary policy can threaten financial stability, and the maintenance of price stability requires a stable financial environment."* *"Policy actions taken for both goals should be consistent and mutually reinforcing where possible."* The same article noted *"Timing problems still present difficulties, and on balance suggest avoidance of pre-emptive easing and readiness to act quickly once the negative consequences of a bust become clear. Again, this can only be symmetric if coupled with monetary policy tightening during the upswing."* The term bust is probably an overly-emotive phrase in terms of describing the housing market at present. Yet the key spirit is a willingness to act aggressively once a sharp turning point has been reached. Recent US financial developments, and seeing a vicious circle of falling asset prices, weak growth, rising unemployment, financial instability, falling asset prices...and so on unfold, will no doubt have played a role. This is despite obvious major differences between the two financial systems in terms of health of the banking sector.

Inflation has taken a back-seat, for now. Arguably, the inflation projections themselves – which do not have inflation returning to within the policy band until 2010 are stretching the Policy Targets Agreement. Yet there is also no doubting the material challenges or "fat-tail" risks when it comes to growth. The risk are small, but the consequences large. For now it's a question of stabilising the macro environment, and worrying about inflation later. **While current action is a prudent path to take, it is nonetheless not without risks.** Today's food inflation figures (up 2.7 percent in the month!) suggest we are in store for another unwelcome quarterly inflation result. The Bank also appears primed for further bad news on the inflation front, with wages not expected to moderate for some time and not until early next year *"before we get an clear indication of the extent to which slower activity is translating into lower underlying inflation."* Moreover, *"having headline inflation above the target increases the likelihood that inflation expectations become unanchored, resulting in the need for costly disinflation in the future."*

Looking at the RBNZ's forecasts, the core story remains centred on a period of household consolidation. The RBNZ expect growth to contract in the June and September quarters by 0.2 and 0.3 percent respectively (we see downside risk to the June estimate), and for

growth to remain subdued for some time. Households will be at the heart of the economic slowdown as they go through a balance sheet de-leveraging process, and in this regard, the Bank's forecasts remain very similar to our own. The RBNZ's inflation forecasts are very similar to presented in June. Inflation peaks near 5 percent in the near-term, before retreating back into the target band over 2010.



How far do rates fall, or where is neutral? This is a question the RBNZ even raised themselves (as well as how fast rates would come down) in their policy assessment. They admit the coming 24 months is going to be very challenging for them (and the economy). History tells us that the first port of call is typically neutral. Historically we've thought of this as being 6 percent (4 percent real and 2 percent inflation (middle of the band)). But it's easy to run the case at present that 7 percent applies (4 percent real plus current 3 percent inflation expectations). Now we can debate this, as arguably they should be concerned with the borrowing rate as opposed to wholesale rate, so the neutral rate should be lower. A real rate of 4 percent seems high given potential growth within the economy. But in an environment of elevated inflation expectations, and inflation remaining outside the target band until 2010, some caution with the neutral rate still needs to apply.

So where to for the OCR from here? This is still very dependant on the currency and inflation pressure. The Bank state that *"if the exchange rate were to fall sharply then, in the absence of a further significant deterioration in the economic outlook, interest rates would likely be held higher than projected."* Our key take out from this is that the reasons for the currency falling will be critical. Hence watch the global scene. We are looking for a 7 percent cash rate by year end and then a pause. A follow up 50bps move now looks a real chance for October, particularly with the RBNZ's growth estimate for Q2 being only -0.2 percent. For now we'll call two 25 bps cuts, one in October and one in December. The election may be a wildcard in

term of the Governor's thinking and we wouldn't entirely rule out a pause in October, particularly with confidence stabilising and the currency under pressure. Remember, the incumbent Governor's prior position was as head of the NZ Treasury so is far more in tune with the realities of the political process. Stepping back, it shouldn't matter and economics should hold sway, so we'll continue to look for a further move south in the OCR, but of 25bps. The bigger picture remains a 200-300 bp fall in rates over time with the wildcard remaining the global backdrop. The risk still looks pointed to a worsening environment. But for now, we'll continue to flag a pause in the cycle at year end, but within the spirit of a declining rate environment.

Financial market implications

The NZD was already under pressure in the lead-up to the MPS. The EUR had broken through the key 1.4000 mark around half an hour beforehand, and the surprise 50bp rate cut just added to selling pressure. The NZD is now around 100bps lower than it was moments before the release.

Interest rates quickly snapped lower across the curve. At this stage, the bellwether 2-year swap is

trading around 18bps lower, at around 7.00 percent. Close attention will now be paid to the magnitude of the flow on effect to borrowers, both floating and fixed.

While the RBNZ has dominated today and opened the door to a continued trend lower in rates and the currency, we expect markets to return to the global picture and backdrop in the next few days. Indeed, the global backdrop was a key reason behind the RBNZ's action, and will no doubt remain influential going forward.

September MPS Projections (June 2008 MPS projections in brackets)					
Half year average	H2 2008	H1 2009	H2 2009	H1 2010	H2 2010
90 day	8.0 (8.5)	7.4 (8.1)	7.2 (7.8)	7.1 (7.3)	6.9 (6.7)
TWI	65.3 (67.8)	63.6 (65.9)	62.5 (64.5)	61.6 (62.9)	61.2 (61.8)
March years	2008	2009	2010	2011	
CPI (ann % chg)	3.4 (3.4)	4.5 (4.4)	2.8 (3.0)	3.0 (2.6)	
GDP (ann ave % chg)	3.0 (3.1)	0.3 (0.9)	1.9 (1.4)	2.9 (2.5)	

Text of the policy assessment

The Reserve Bank today reduced the Official Cash Rate (OCR) by 50 basis points from 8.0 percent to 7.5 percent.

Reserve Bank Governor Alan Bollard said: "The New Zealand economy is experiencing a marked slowdown, led primarily by the household sector. The outlook for the global economy has deteriorated further in the wake of continued financial market turmoil. In addition, the New Zealand business sector is coming under pressure from both rising costs and falling demand. While domestic activity is likely to pick up late this year as a result of personal tax cuts, increased government spending and rising rural incomes, we expect a prolonged period of household sector adjustment and below-average growth.

"The weakness in economic activity is expected to translate into lower inflation pressures in the medium term. Headline inflation is expected to peak around 5 percent in the current September quarter before trending down thereafter. However, food price inflation, exchange rate depreciation and higher wage costs will tend to keep headline inflation at elevated levels through 2009.

"With medium-term inflation pressures expected to ease, it is appropriate to move towards a less restrictive monetary policy stance. Compared to the June Monetary Policy Statement, we have brought forward some of the projected interest rate reduction, but have not altered the expected overall decline. We believe this response is warranted in light of the tightness of current credit conditions and the time it will take to affect the actual interest rates faced by households and businesses.

"Looking ahead, the scale and timing of further official cash rate reductions will depend on signs of declining inflation pressures and on exchange rate adjustments."

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The Bank (in respect of itself and its principal officers) makes the following investment broker disclosure to you pursuant to section 41G of the Securities Markets Act 1988.

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- Associate Member of Investment Savings & Insurance Association of NZ;
- Financial Markets Operations Association; and
- Institute of Finance Professionals.

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The insurer is ANZcover Insurance Pty Limited.

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- A principal officer of a body corporate when that body corporate committed any of the offences or crimes involving dishonesty as described above;
- Adjudicated bankrupt;

- Prohibited by an Act or by a court from taking part in the management of a company or a business;
- Subject of an adverse finding by a court in any proceeding that has been taken against them in their professional capacity;
- Expelled from or has been prohibited from being a member of a professional body; or
- Placed in statutory management or receivership.

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- New Zealand and overseas unit trusts;
- Share in a limited partnership;
- Superannuation schemes and bonds;
- Group investment funds;
- Life insurance products;
- Derivative products including interest rate and currency forward rate contracts and options; and
- Other forms of security, such as participatory securities.

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- Providing a cheque payable to the relevant product or service provider and crossed 'not transferable'; or
- Making an automatic payment or payment through another electronic delivery mechanism operated by the Bank.

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Any investment money lodged with the Bank for the purchase of securities offered by the Bank, its subsidiaries or any third parties will be deposited in accordance with your instructions, to your nominated account or investment. Such money will be held by the Bank according to usual banking terms and conditions applying to that account or the particular terms and conditions relating to the investment and will not be held by the Bank on trust unless explicitly accepted by the Bank on those terms. Any investment money or property accepted by the Bank on trust will be so held until disbursed in accordance with your instructions. Any investment property lodged with the Bank will be held by the Bank as bailee according to the Bank's standard terms and conditions for holding your property.

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