

RBNZ Official Cash Rate Review

Key points

- > RBNZ cut the OCR by 25bps to counter tighter financial conditions from other areas.
- > Higher global cost of funds played an important part in today's decision.
- > Weaker economic activity giving the RBNZ confidence that medium-term inflation pressures will ease.
- > Further easings flagged, but this is dependent on the inflation outlook and how the NZD evolves.
- > We see a staggered easing cycle with cuts at each meeting for the rest of this year, then a pause to assess the economic and inflation situation, before a resumption of the easing cycle in mid-2009. Commodity prices remain key to watch.

Assessment

The RBNZ reduced the Official Cash Rate (OCR) by 25bps, taking it to 8.00 percent. Today's decision was in line with our call (which to be fair we lacked conviction over). However, it caught the market, which was expecting the status quo, by surprise. There was never any doubt that economic activity is far weaker than the RBNZ's June projections. This was acknowledged by the RBNZ when it noted more *"unpleasant international news"* and saw the risk that the domestic economy will slow further.

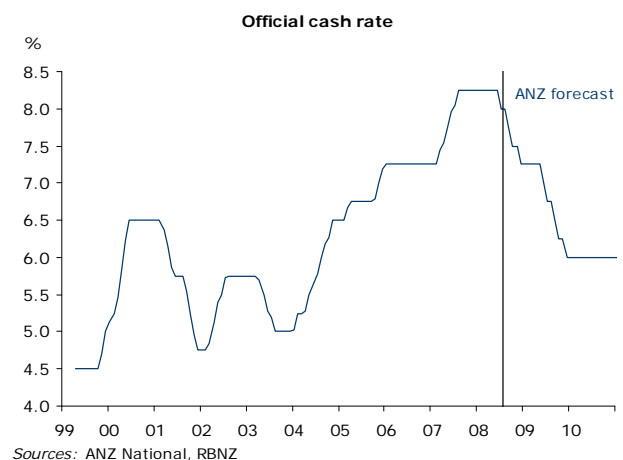
Tighter financial conditions have obviously been influential, with the RBNZ noting *"the cost of funds raised abroad by banks has been rising in recent months as the international financial situation has deteriorated. Today's cut will help to mitigate the effect of these increases on the actual borrowing costs paid by firms and households."* In this situation, relief via wholesale interest rates is needed just to keep retail borrowing rates from moving up, thereby tightening financial conditions.

The RBNZ now see growth as even weaker than envisaged in June. *"Economic activity is likely to remain weak over the remainder of 2008"*. We see this as acknowledgement that the recovery built into the RBNZ's June projections in H2 following a stalling in H1 does not look set to eventuate. In addition, the recovery is seen as *"gradual"* through 2009 – a clear indication that the RBNZ's next set of projections to be released in September will incorporate downward revisions to their 2008 and 2009 outlook.

Of course, inflation risks remain, with the headline inflation rate set to peak at 5 percent in Q3. A high headline inflation rate, and the fact that inflation expectations remain elevated, were always sticking points to a July rate cut. But the deteriorating growth picture has given the RBNZ greater confidence that medium-term inflation pressures will ease. The RBNZ is making two crucial judgements in this regard. First, weak demand makes it *"more difficult for firms to pass*

on costs", and second, wage setting behaviour will not respond to a near-term blip in inflation, once again as the demand side of the equation dominates. Both are judgments we agree with.

There will be detractors who say the RBNZ is risking a blow-out in inflation by easing now. Certainly, any policy response takes on a degree of risk. However, we also need to be cognisant of the economic reality of the current situation. The RBNZ is being 100 percent consistent when you compare today's decision with their approach last year. Then, they hiked rates even though near-term inflation was heading towards 1.5 percent, preferring to focus on medium-term pressures. The same approach is being adopted at present. In any event, the OCR is sufficiently high that a rate cut now is hardly going to result in the economy reflatting, particularly as it will merely offset the tightening being delivered via the credit channel of monetary policy. We see today's actions as merely helping to stabilise a clearly rapidly deteriorating environment.



With the easing cycle now commenced, we see further rate cuts ahead as flagged. However, with inflation still set to remain above the 1-3 percent target band until the second half of next year, and the RBNZ's concern over the NZD falling too far too fast,

we see them staggering the easing cycle. We are looking at 25bp easings at each meeting for the rest of this year to take the OCR into less restrictive territory (7.25 percent by end of this year), followed by a pause to assess the economic and inflation outlook. We see a fair bit of "chicken and the egg" in terms of how the rates and currency market will react. We then see the resumption of the easing cycle in mid-2009, taking the OCR towards neutral.

However, if we continue to see commodity prices decline such as we have during the past week, we would be more inclined towards a steady continuation of cuts towards the perceived neutral level in a quicker fashion. In this situation, the reflationary or inflationary risk from a lower currency will be mitigated.

Financial market implications

With the market heading into the decision split 50:50, there was always going to be a reaction either way. The rate cut saw swaps rally across the board, with the 2-year swap yield falling to 7.41 percent. Bank bill futures also joined in the rally, and the market is now fully pricing in 25bp rate cuts at each meeting until March 2009. The NZD sold off around 70pips, and will remain heavy as NZ's yield advantage is now finally starting to narrow. It is now partly up to the currency market (as well as commodities) to dictate by how much further the easing cycle goes. Expect the swaps market to trade with a strong receive side bias, but keeping a careful watch on the NZD and commodities.

Text of the OCR review below:

The Reserve Bank today reduced the Official Cash Rate (OCR) from 8.25 percent to 8.0 percent.

Reserve Bank Governor Alan Bollard commented that "more unpleasant international news has emerged since the June *Monetary Policy Statement*, and there is a risk that the domestic economy will slow further. Moreover, the cost of funds raised abroad by banks has been rising in recent months as the international financial situation has deteriorated. Today's cut will help to mitigate the effect of these increases on the actual borrowing costs paid by firms and households.

"Recent oil and food price increases mean that annual CPI inflation should peak around 5 percent in the September quarter of this year. However, we expect that inflation will return inside the target band in the medium term. The weaker economy is expected to reduce pressure on resources, making it more difficult for firms to pass on costs and for higher wage claims to be agreed.

"Economic activity is likely to remain weak over the remainder of 2008. The ongoing correction in the housing market, together with the very high oil prices, will limit household spending and constrain the extent of recovery. However, high export prices and an expansionary fiscal policy are expected to contribute to a gradual pickup in activity through 2009.

"Consistent with the Policy Targets Agreement, the Bank's focus will remain on medium-term inflation. In this regard, it is important to note that monetary policy has been reasonably tight for some time, and is now restraining activity and medium-term inflation pressures. Provided that the outlook for inflation continues to improve and there is no excessive exchange rate depreciation, we would expect to lower the OCR further."

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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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- 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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- 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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The Bank will keep adequate records of the deposit of investment moneys or property and all withdrawals and dealings with such money or property, using the account/investment number allocated to your investment. You may have access to those records upon request.

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