

RBNZ Official Cash Rate Review

Key points

- > **The RBNZ reduced the OCR by 150bps to 3.5 percent, and left the door open for further cuts.**
- > **Deteriorating global prospects and the ongoing uncertainty of the international environment played a large part in today's larger than expected rate cut.**
- > **Inflation is no longer a concern for the RBNZ, with the Bank having confidence that inflation will be comfortably inside the target band over the medium term.**
- > **With the global and domestic picture still deteriorating, and other tactical considerations a red herring, it is hard to go past a terminal cash rate of 2 to 2.5 percent.**

Assessment

The RBNZ "surprises" with a larger than expected rate cut. Given the marked deterioration in the New Zealand and global economies, a large rate cut was always on the cards. The big question was how large. The RBNZ decided on a 150bp cut, taking the OCR to a new low of 3.5 percent. Still, today's move was not totally unexpected, with the OIS market pricing in around 130bps of cuts heading into the decision.

The deteriorating and uncertain global environment played a large part in today's decision. Inflation is no longer a concern, with the RBNZ having *"confidence that annual inflation will be comfortably inside the target band of 1 to 3 percent over the medium term."* The global outlook and how this will impact on the New Zealand economy is the predominant concern for policy. Hence, with the inflation roadblock now removed, the RBNZ felt the need to *"take the OCR to a more stimulatory position and to deliver this reduction quickly."*

Given the global and domestic backdrop, it is easy to agree with the spirit of what the RBNZ is trying to achieve. It now looks increasingly likely that the terminal cash rate will be closer to 2 percent than the 3 percent that we had originally thought. Certainly, the historical experience has been that New Zealand interest rates usually end up around 1 percent above the average of our trading partners during downturns. Looking across Europe, Australia, the UK, Japan and the US, one percent seems the prime number, which gives an endpoint of 2 percent in New Zealand.

Further rate cuts have been flagged and are dependent on how the economy responds to the stimulus imparted to date. In a change of tone, the Governor now expects the economy to remain in recession until the middle of this year.

The front loading of policy to date (475bps of rate cuts since July 2008), together with a lower currency and fiscal stimulus, should provide support to growth, but this may take time given the usual lags. However, we also have to recognise that all these measures can do is help mitigate the downside extremes in the economic cycle. The headwinds hitting the New Zealand economy from offshore forces are unprecedented.

How businesses and households respond to the current economic climate is of concern to the RBNZ, with the statement noting that any positive policy impact on growth is on the proviso that *"firms and households do not unnecessarily contract their spending."* No doubt the Bank is keen to avoid the situation whereby businesses put up the shutters and consumers close their wallets, causing the unemployment rate to rise, leading to further reduction in spending, lower profits, fewer jobs and so on. A circuit breaker is needed, in such a scenario, to stop the spiral from getting out of control, and the RBNZ has been prepared to use their OCR policy lever to do just that. It is clear that structural and tactical considerations are red herrings at this point, and the RBNZ's prime focal point is on the business cycle and getting relief in – immediately. But herein resides the dichotomy: the RBNZ needs a stronger housing market in the near-term to stabilise the macro economy, but a further adjustment in that sector is a pre-requisite to improving the external position. This is an area that continues to nag at us. But for now such considerations are clearly not influential in terms of the RBNZ's decision making process.

Going forward, we see two avenues as being critical to watch, in light of *"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."* Obviously it is far too early to

look for stabilisation within the global and domestic economies. Also, poor local labour market statistics will have the market biased one way and pushing for further rate reductions.

The first avenue is global credit conditions, with stabilisation and improvement a prerequisite to improving real economic conditions. With a possible lag of up to 15 months between the impact of the financial crisis on the real global economy, the latter will continue to press for rate cuts, while it will be the former that ultimately signals a recovery – though some way out – is pending. At present it is fair to say that financial conditions are improving, slowly, but markets remain volatile. On the assumption that credit conditions continue to ease (a big assumption) and monetary policy gains traction, considerable policy pipeline support is set to hit from mid 2010.

The second is the housing market, which the RBNZ obviously needs to “draw” out of its

retrenched mode with massive rate cuts. Particularly given that the economy is lacking any real alternative to pull it out of the hole it is currently in (excluding fiscal policy).

Collectively, we see little at present to stand in the way of the OCR continuing to hit historical lows and matching the historical experience of troughing one-percent above our trading partners. While the RBNZ is obviously seeking to slow the pace of easings from here, such a desire may prove difficult, particularly given the tenor of upcoming labour market data. But increasing the front-loading process also suggests the RBNZ is already factoring in extremely weak data, and a lot may depend on how early the housing market starts to respond.

We’re pencilling a series of further 50 basis point moves from here with a final terminal rate of around 2 to 2.5 percent.

Text of OCR Review below

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.

“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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