

### RBNZ March *Monetary Policy Statement* Review: The glide path

#### Key points

- > The RBNZ cut the OCR by 50bps to 3 percent, in line with our expectations.
- > The nuances in the economic assessment are very similar to our own views, though we still remain more bearish on the economy compared to the RBNZ.
- > The end game looks to be a 2.5 percent trough in the OCR, which we expect the RBNZ to get there via two further 25bp cuts in April and June.
- > The RBNZ has already factored in weak data over the coming months so data will have to be far weaker to extract further policy moves.
- > While we believe this condition will be satisfied, the ultimate release valve in our eyes needs to be the currency. Hence, we continue to pick a 2.5 percent OCR trough, but a far weaker NZ dollar.

#### Assessment

**The RBNZ cut the Official Cash Rate (OCR) by 50bps to 3 percent as we had expected.** The combined effects of a weaker domestic economy and global frailty have weighed heavily, both in terms of today's decision and those taken collectively to date. This is reflected within the RBNZ's economic projections which now see the economy contracting through until mid 2009, and the most prolonged recession since the 1970s. In such a situation it is clear that policy needs to act.

**The RBNZ game plan?** Reading between the lines, looking at the 90-day projections (a trough in the 90-day rate of 3 percent) and based on statements made by the Governor at the press conference, the end game looks to be a 2.5 percent bottom in the OCR. This is of course subject to the economic outlook evolving in line with the Bank's projections, which is also noted as having "downside risks". The Governor dispelled any notions that rates in New Zealand would head towards near-zero like in some other countries. Small open nations such as New Zealand that are reliant on offshore capital face a constraint in terms of how low rates can go. For New Zealand this likely floor resides around 2 percent (zero real rates plus inflation at the mid-point of the policy band). Hence, flagging 2.5 percent still leaves the RBNZ with potentially 50bps up their sleeve. It also means watching the RBA, with maintaining competitiveness in capital markets a consideration. Moreover, there is a clear strategy to try and wean the market off super-sized rate cuts that they had become accustomed to of late. In the words of the Governor, we are now at the "glide-path" stage for policy. By delivering only 50bps today and outlining that "any future cuts will be much smaller than observed recently", the RBNZ is signalling a

return towards more normal policy changes.

**Hence, we are looking at two further 25bp cuts in April and June.**

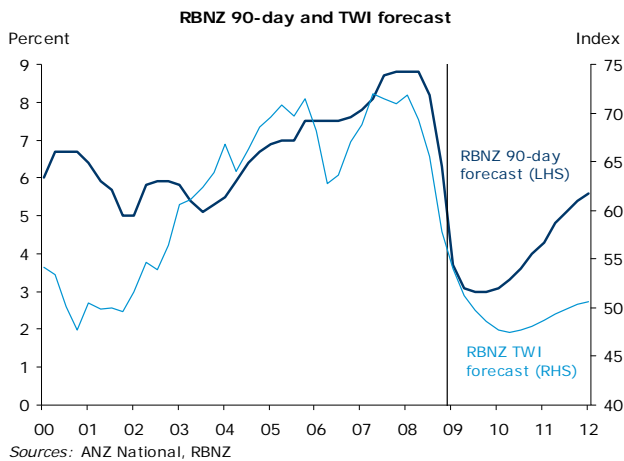
**In terms of the RBNZ's projections, unsurprisingly, they have downgraded their assessment of growth to -1.1 percent for calendar 2009.** The Bank expects GDP growth to contract until Q2, with a somewhat surprisingly solid rebound thereafter. By March 2011, the economy is growing close to 5 percent. Monetary and fiscal policy stimulus delivered to date, together with recent large declines in the currency, are behind this recovery in the second half of this year and going forward. But this view is also predicated on:

- > global financial markets stabilising;
- > trading partner growth turning modestly positive early next year; and
- > credit conditions start to improve later this year.

**Inflation is not a concern.** The RBNZ sees headline inflation temporarily head below 1 percent in Q3, before returning to around the middle of the target band for the remainder of the projection period. The removal of the Emissions Trading Scheme accounted for part of the improved inflation outlook, but so too weaker economic activity, lower commodity prices and lower inflation expectations. All up, inflation is not a predominant policy concern, though at the same time, the RBNZ do not see much risk that it could fall below the target band either.

**Other interesting aspects to the projections themselves include:**

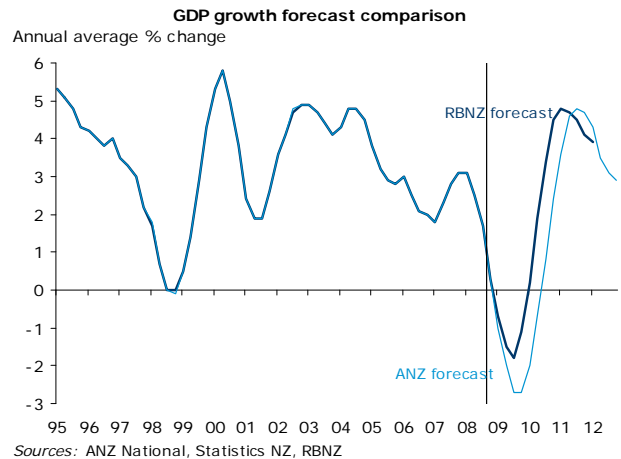
- > Explicit recognition of structural aspects to the economic cycle, namely a rebalancing away from debt-fuelled domestic consumption towards export orientated growth. Consumption is anaemic for three more years. Themes that resonate strongly with our own economic view.
- > A trough in the 90-day of 3 percent and a very gradual rise in 2010. While partially model and technically driven, the story remains one of rates remaining low for sometime.
- > A further 10 percent envisaged fall in the NZD, and expectations the TWI remains sub 50 on average over the coming 3 years. While currency forecasting is a mug's game at the best of times, such a dynamic also fits within the structural rebalancing process the RBNZ and ourselves both envisage.



The issue will now turn to whether the upcoming data is even weaker or more disappointing than what the RBNZ has factored in, so as to fundamentally change the medium-term outlook.

**Our own assessment on the economy is more downbeat.** We envisage more sizeable contractions in quarterly GDP going forward (-0.9 and -1.5 percent for Q4 2008 and Q1 2009 respectively, versus the RBNZ's -0.8 percent for both quarters) and also a bigger rise in the unemployment rate. We see GDP growth for calendar 2009 contracting by closer to 3 percent, compared to the RBNZ's -1.1 percent view and the sustained recovery being six months later. To be fair, the Bank notes the extremely large uncertainty surrounding their projections, and sees the risks skewed to the downside. Nonetheless, the RBNZ is expecting the run of bad data to continue for a few more months, and has been at pains to point that out in an attempt to prevent the market from front-running it too far. Specifically, the RBNZ noted that *"some of the easing was also in anticipation of the future negative effects of the global economy on New Zealand."* This is something for the markets

to bear in mind with upcoming data. Hence, "bad" data in itself need not materially change the outlook for policy. We believe the data will be beyond being simply "bad". In fact, to be hitting the RBNZ's H2 2009 growth forecasts, we will need to see some immediate recovery in the key leading indicators from about April. Note specifically that in terms of key economic indicators, a lot of attention will be paid to the Q1 HLFS report (due 7 May), where the RBNZ expects the unemployment rate to increase to 5.2 percent (from 4.6 percent currently).



**Looking forward, we expect the overall tenor of news to keep the market looking for more on the rate cut front as opposed to less, or at a minimum dispelling notions that rates will move up in early 2010. However, we continue to stop short of calling movements in the OCR below 2.5 percent.**

**We continue to favour a far weaker NZD as the release valve that weakness in the economy needs to, and ultimately will be, expressed through.** This is predicated off our long-held view that structural aspects to this cycle are being downplayed. In a de-leveraging and de-risking global environment, New Zealand needs to do the same. A lower currency is a critical aspect to restoring some much needed balance to growth.

### Implications

**With some 70bps priced in heading into today's decision, the 50bp cut saw bank bills sell off.** The entire swap curve sold off with the curve flattening following the decision, which was rather surprising given that market pricing for the OCR trough had been at around 2.5 percent, in line with where the RBNZ signalled it was heading. Receivers started to return later in the morning, but swap yields remain higher. We consider such movements not much more than noise, and the focus will quickly return to the tenor of data, which we expect to remain very downbeat.

**Moving forward, with the easing cycle coming closer to an end, we expect swaps to range trade in the near-term.** We still expect more steepening pressure on the curve as more corporate paying emerges on the long end. But given the scale of global challenges it is hard to go past a general expectation that rates are staying at a low level for some time, which will keep front end yields down. **Our main focus will remain the currency, which is the next leg that weakness in the economy needs to play out.**

RBNZ Projections for March MPS (December 2008 MPS Projections in brackets)					
Half year average	H1 2009	H2 2009	H1 2010	H2 2010	H1 2011
90 day	3.4 (5.4)	3.0 (5.1)	3.2 (5.3)	3.8 (5.7)	4.6 (..)
TWI	52.6 (54.3)	49.2 (52.8)	47.5 (52.7)	47.9 (53.8)	49.0 (..)
March years	2008(a)	2009	2010	2011	2012
CPI (ann % chg)	3.4	3.1 (3.1)	1.6 (2.7)	2.2 (2.3)	2.1 (..)
GDP (ann ave % chg)	3.1	-0.8 (0.1)	0.2 (1.3)	4.8 (4.3)	3.9 (..)

### Full text of the Policy Assessment

The Reserve Bank today reduced the Official Cash Rate (OCR) by 50 basis points to 3 percent.

The world economy deteriorated very rapidly late last year, amid ongoing losses and extreme volatility in international financial markets. While monetary and fiscal policy responses in many countries have been substantial we still expect the adverse economic forces generated by the crisis to remain dominant throughout 2009. The timing and extent of global recovery remain highly uncertain.

In New Zealand, the impact of difficult trading conditions is showing through clearly in reduced export revenues, weak business sentiment, and sharply curtailed investment and employment. Further house price falls and increased precautionary saving by households are driving a weakness in spending. Inflation pressure is abating rapidly as a result.

The OCR has now been reduced 525 basis points in little more than six months, taking interest rates to very stimulatory levels. Further falls in the lending rates faced by households and businesses are in the pipeline. While credit growth is easing in line with the weak economy, we expect financial institutions to continue lending on sound business propositions, to support the recovery.

In addition to the substantial change in monetary policy settings, there has been a large amount of stimulus from fiscal policy. These policy changes, together with the sizeable exchange rate depreciation, will act to support the New Zealand economy: therefore, we expect to see activity troughing in the middle of this year and then gradually picking up thereafter. However, the scale of the global financial crisis is such that there is great uncertainty about future economic developments and there is a risk that the recovery may occur later and be more protracted than we anticipate.

As economic activity troughs, we expect the rapid easing of monetary policy to slow. Any future cuts will be much smaller than observed recently. We do not expect to see in New Zealand the near-zero policy rates of some countries. New Zealand needs to retain competitiveness in the international capital markets. We will assess the need for further cuts in the OCR against emerging developments in the global and domestic economies and the responses to policy changes already in place.

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- Share in a limited partnership;
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