

RBNZ December *Monetary Policy Statement*

Key points

- > The RBNZ delivered a 150bps cut, taking the OCR into “*expansionary*” territory at 5 percent.
- > Once again, it was financial market turmoil and the deteriorating global backdrop that were the key drivers in today’s decision.
- > Given our view that the RBNZ is still too optimistic on prospects for the domestic and global economy, we ultimately see the endgame as involving the OCR falling below 4 percent as policy takes an even more stimulatory stance.
- > However, something we are increasingly turning our attention to is the inevitable policy normalisation that will follow.

Assessment

The RBNZ delivered on both market and economists’ expectations this morning, reducing the OCR by an unprecedented 150bps, taking it into what it calls “*expansionary*” territory at 5 percent. The RBNZ has now cut the OCR by 25bps in July, 50bps in September, 100bps in October, and now 150bps in December; for a cumulative reduction of 325bps. Despite this, the RBNZ is far from done, and further rate cuts have been signalled, though the moves will be considerably smaller than what was delivered today.

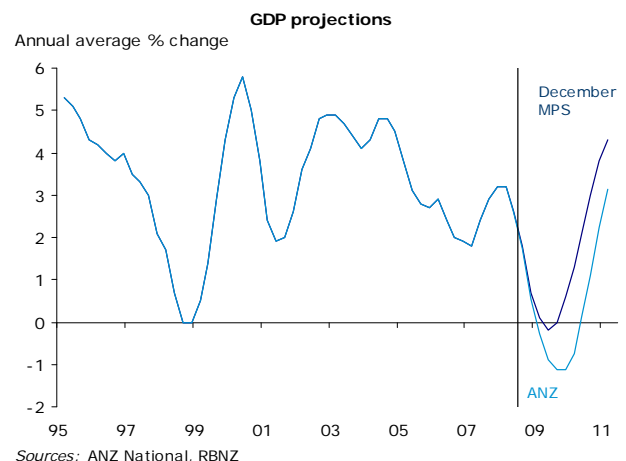
The deteriorating global backdrop and the flow on impact on the NZ economy were clear factors shaping the RBNZ’s decision today.

And it is this backdrop that will continue to determine the extent of future easings. Given our view that the RBNZ’s projections for the NZ economy still look on the optimistic side (annual average GDP growth bottoming out at only -0.2 percent by mid 2009), and the Bank’s acknowledgement that the international dataflow has been weaker than what was assumed in their trading partner growth forecasts, we see the 90-day rate heading well below the RBNZ’s 5.1 percent projected trough (we are already very close to there already, with the 90-day rate currently at 5.36 percent). This, despite monetary conditions now in stimulatory territory, a lower NZD, and further fiscal stimulus to come. Our forward looking *Taylor Rule* estimates are already consistent with a 4 percent OCR.

Inflation and growth risks are noted as being on the downside.

On the latter point, weaker global growth and the impact of global credit pressures are seen as weighing on the NZ economy. On the inflation front, despite the RBNZ’s view that certain non-contestable related

inflation pressure will persist for longer than expected, they see a chance that headline annual inflation could briefly fall to the bottom of the target band – an amazing turnaround from the start of the year.



However, domestic inflation pressure, particularly in the non-contestable parts of the economy, continues to concern the RBNZ.

Electricity and local authority rates again received a mention. But weaker growth and falling petrol prices will take inflation comfortably within the target band, even if the emissions trading scheme is included (assuming it is back on the table from 2010).

There has been a big shift in tone in today’s

Statement. The RBNZ now sees “*considerable slack*” starting to build up, which will help eventually suppress non-tradable inflation. The role that the credit channel of monetary policy (availability and price of credit) is playing, something we have been alluding to in our research for some time, is becoming a “*significant policy consideration*” for the RBNZ as well. While this is an area that is very difficult to assess, this channel

represents a significant offset to the traditional monetary transmission mechanism, requiring rates to fall more aggressively below perceived views of neutral (which we typically assess as being around 5.5 to 6 percent).

The big picture remains that interest rates will continue to move lower given the risks that we see manifesting into reality for inflation and growth. Some degree of uncertainty will still surround the timing and potential magnitude of further cuts. The Reserve Bank explicitly noted that *“further, but significantly smaller, reductions in interest rates may be warranted”*, but the timing and magnitude remains uncertain.

We expect the RBNZ to continue moving early as opposed to later, but in a more steady manner (if we could term 50bps moves as steady!) going forward, subject of course to the normal caveats about the global environment. But the endgame ultimately looks set to involve the OCR falling below 4 percent. We are looking for a 50bp cut in January, subject to no further substantial deterioration in the global scene (a big assumption at present) and the government delivering a sizeable fiscal stimulus package before Christmas to assist monetary policy in stabilising the economy.

One danger we are acutely wary of at present is the risk of being hyped up in terms of interest rate cuts as a consequence of an awful economic environment, and ignoring some wider considerations. Around the global there is a huge amount of reflationary stimulus being thrown at the international economy. The RBNZ (in a similar fashion to the RBA) acknowledge the *“substantial support to demand over the period ahead”* that is set to hit the NZ economy. Certainly, this stimulus is required at present given the international scene. Yet, at the risk of responding to one crisis (and policymakers can only manage one at a time), another risks being created down the track, namely inflation. This seems a tall ask at present given the dis-inflationary (deflationary?) forces that are dominating, including collapsing demand, falling commodity prices and easing inflation expectations. We are certainly of

the view that rates will move lower from here. But we must not lose sight of the bigger picture: consumer driven excess reside at the heart of global imbalances, and correcting internal imbalances within a lot of nations ultimately require a combination of higher interest rates but a lower currency. In the current de-risking environment, that conventional positive relationship between the two no longer applies. The global stimulus package is massive, with quantitative easing now being adopted in a number of nations. At some stage, this will portend of inflation, which historically has been how household (and corporate) balance sheets have been repaired.

So while we continue to look for rate cuts near-term, we are also mindful as to when the potential turning point could be. One thing seems for sure. Interest rates, when they start to move back up (subject to the global scene), will not be in the 25bps increments that was the trajectory during the previous RBNZ tightening cycle.

The bottom line

The RBNZ now acknowledges that the transmission of global developments to NZ has become *“clearer”*. The economic and interest rate projections (and actions) reflect that fact. At present we continue to view their economic projections as sitting at the optimistic end. With global developments still unfolding (deteriorating) rapidly, any economic assessment in the current environment has a relatively short shelf-life.

Looking forward, we expect a series of 50 basis point reductions starting in January, ultimately taking the OCR to 3.5 percent by April 2009.

From a markets perspective, today's statement has endorsed market expectations as to further falls in interest rates. The muted currency reaction, and then brief fillip following a late recovery in the Dow Jones, is testament to the reality that currency markets are now firmly focused on risk metrics as opposed to yield. We expect this sentiment to continue for some time.

RBNZ December MPS Projections (September MPS projections in brackets)

Half year average	H2 2008	H1 2009	H2 2009	H1 2010	H2 2010
90 day	7.4 (8.0)	5.4 (7.4)	5.1 (7.2)	5.3 (7.1)	5.7 (6.9)
TWI	61.8 (65.3)	54.3 (63.6)	52.8 (62.5)	52.7 (61.6)	53.8 (61.2)
March years	2008(a)	2009	2010	2011	
CPI (ann % chg)	3.4 (3.4)	3.1 (4.5)	2.7 (2.8)	2.3 (3.0)	
GDP (ann ave % chg)	3.2 (3.0)	0.1 (0.3)	1.3 (1.9)	4.3 (2.9)	

Text of the policy assessment

The Reserve Bank today reduced the Official Cash Rate (OCR) from 6.5 percent to 5.0 percent.

Reserve Bank Governor Alan Bollard commented that "ongoing financial market turmoil and the marked deterioration in the outlook for global growth have played a large role in shaping today's decision. Activity in most of our trading partners is now expected to contract or grow only very slowly over the next few quarters.

"Economic activity in New Zealand will be further constrained as a result, compared with our view in October.

"Inflation is abating here and overseas as a consequence of these developments. We now have more confidence that annual inflation will return comfortably inside the target band of 1 to 3 percent some time in the first half of 2009 and remain there over the medium term. However, we still have concerns that domestically generated inflation (particularly local body rates and electricity prices) is remaining stubbornly high.

"Today's decision brings the cumulative reduction in the OCR since July to 3.25 percent, and takes monetary policy to an expansionary position.

Given recent developments in the global economy, the balance of risks to activity and inflation are to the downside. Thus it is appropriate to deliver this reduction quickly to support the economy and keep inflation from falling below the target band.

"Monetary policy is working together with the depreciation of the New Zealand dollar and the fiscal stimulus now in train, to provide substantial support to demand over the period ahead and to create the conditions for some rebound in growth as global conditions improve.

"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.

"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."

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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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- Equity securities such as listed and unlisted shares;
- 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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If you wish to pay investment money to the Bank you can do this in several ways such as by:

- Providing cash;
- 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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