Economic Research
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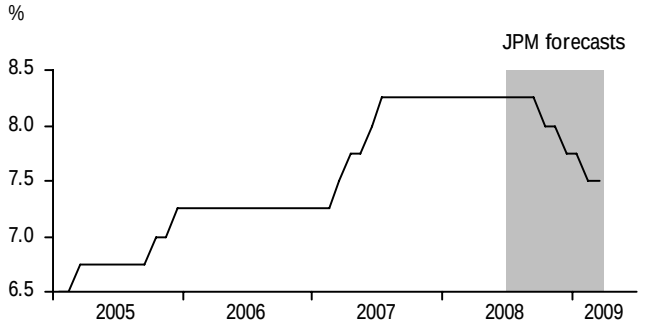
New Zealand economic update

RBNZ left rates on hold at record 8.25%

The RBNZ left the official cash rate (OCR) steady at a record 8.25% as expected this morning, citing upside risks to inflation and downside risks to economic growth. The OCR has remained unchanged since July 2007, although will probably fall toward the end of 2008. Dr. Bollard said that, "Provided the economy evolves in line with our projection, we [the RBNZ] are now likely to be in a position to lower the OCR later this year".

We maintain our forecast that the RBNZ will begin to ease monetary policy in October. Our forecast calls for a 25bp rate cut in October and December, and another rate cut in 1Q 2009, taking the key rate to 7.50%. There is no scheduled monetary policy meeting in October this year.

New Zealand: RBNZ official cash rate



RBNZ Governor Bollard said that New Zealand is now facing a "challenging environment of weak activity and high inflation". On inflation, the RBNZ expects annual CPI to peak at 4.7% in 3Q, mainly owing to higher food and energy prices, before returning to within the target 1-3% band in the medium-term. This forecast, though, is based on expectations that "commodity prices stop rising, inflation expectations remain anchored, and weakening economic activity contributes to an easing in non-tradables inflation". Indeed, non-tradables inflation remains elevated, even though domestic demand has eased, and there is a risk that firms and workers start negotiating higher wages amid expectations of persistently high inflation. In the accompanying Monetary Policy Statement (MPS), the RBNZ said that it would have to respond to changing price behaviours with higher interest rates than currently assumed.

On the economy, Governor Bollard highlighted that since the central bank's last MPS in March that economic activity had weakened further. The Bank forecasts GDP growth of just 0.9% in the March 2009 year. The household sector remains weak, and the negative wealth effects from the sharp deterioration in the housing

market are creating significant headwinds for the household sector, which is already under pressure from high borrowing costs and rising prices for staples, such as food and petrol. Furthermore, the bank highlighted that consumer and business confidence has eased, and that the labour market has started to loosen. Employment growth contracted in 1Q and wage growth moderated; this will have further negative implications for household spending growth in the near-term. Government spending and personal tax cuts will provide "some offset", however.

On the exchange rate, which dropped one cent against AUD immediately after the Statement, the RBNZ noted that the NZ dollar had depreciated recently, and that there is a risk that the currency could fall even faster going forward. This would promote a rebalancing of growth away from the household sector toward the external sector. The RBNZ forecasts, though, that the NZ dollar will steadily depreciate over the projection period.

As upside pressure on inflation persists, economic growth will slow to a standstill in coming quarters. Dr. Bollard said a recession is possible, even though it is not officially forecast by the RBNZ. We currently forecast two negative quarters of growth in 1Q and 2Q. But, despite that economic growth will probably stall, widespread inflation pressures will prevent the RBNZ from easing monetary policy prior to the December quarter. Pipeline pressures continue to build, non-tradables inflation remains elevated, and inflation expectations are rising. The RBNZ said that interest rates, which it believes are currently above neutral, will remain unchanged until it is confident that "medium-term inflation pressures are easing".