Economic Research
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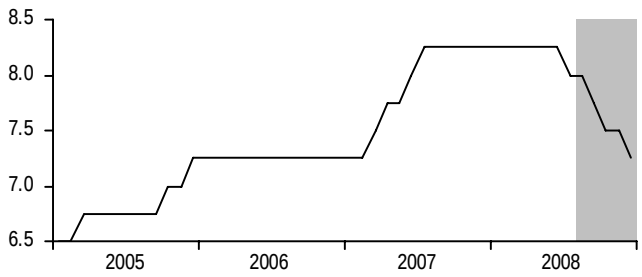
New Zealand economic update

RBNZ cuts OCR

The RBNZ cut the official cash rate (OCR) by 25bp to 8.00% this morning (JPMorgan and consensus 8.25%). Only four of 13 market economists expected a rate cut at today's meeting.

New Zealand: RBNZ official cash rate



We had believed that widespread inflation pressure, particularly the elevated level of non-tradable inflation, would keep the RBNZ sidelined until September. In particular, we believed that leaving the OCR steady this month would have allowed time to assess whether the weakness in employment reported in 1Q had been sustained; hence, signaling that upside pressure on wages may abate.

RBNZ Governor Alan Bollard highlighted in the statement announcing the decision that "more unpleasant international news" had emerged since the last meeting. Financial conditions had worsened and the cost of funds raised aboard by banks had been rising. Lowering the OCR will help to mitigate the effect of these increases on borrowing costs paid by firms and households, according to Dr. Bollard.

On inflation, the RBNZ now expects CPI growth to peak at 5.0% in 3Q, compared to its previous forecast of 4.7%. In the medium-term, though, the RBNZ expects that inflation will return to within the bank's 1-3% target range as economic growth moderates. Economic activity is forecast to remain weak for the remainder of the year, owing to the dampening effect on household spending of the rapidly deteriorating housing market and rising oil prices. Furthermore, monetary policy settings, which have been tight for some time (the OCR has been at a record high since July 2007), are also curbing growth.

Dr. Bollard said that provided the outlook for inflation evolves as expected over the medium-term, **the OCR will likely be lowered further**. We believe that the RBNZ has now embarked on what will be an extended easing cycle, with the next cut in rates likely to be delivered in September.

The one key risk to the rate outlook is the risk of a sharp fall in the NZ dollar, which dropped nearly one cent against NZD immediately after the announcement. The downside for the currency should be limited, however. Many investors already have exited carry trades and reduced holdings of higher yielding currencies, such as NZD, amid heightened risk aversion. Also, NZD should retain some interest-rate derived support given the OCR will remain relatively high even if the RBNZ cuts the OCR at each of the three scheduled meetings remaining this year (September, October, and December).

On the upside, a weaker NZD should help growth recover to 1.8% in 2009 from our forecast of 0.8% in 2008. The economy should benefit from increased exports, lower interest rates, personal income tax cuts, increased government spending, and less drag from the housing market. Governor Bollard said today that he expects a recovery in economic activity next year thanks to “high export prices and an expansionary fiscal policy.”

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