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Economic Research note

RBNZ easing will prevent prolonged recession

- **Shallow economic recession forecast in 2008**
- **RBNZ to cut cash rate another 75bp this year**
- **Inflation to peak at 5.2%oya in 4Q**

RBNZ Governor Alan Bollard signaled in June that softer economic growth and the prospect of easing medium-term inflation were paving the way for the official cash rate (OCR) to fall. In July, amid signs of further deterioration in the New Zealand economy, the RBNZ embarked on what we believe will be an extended easing cycle. It cut the OCR 25bp to 8.0%, the first rate cut in five years.

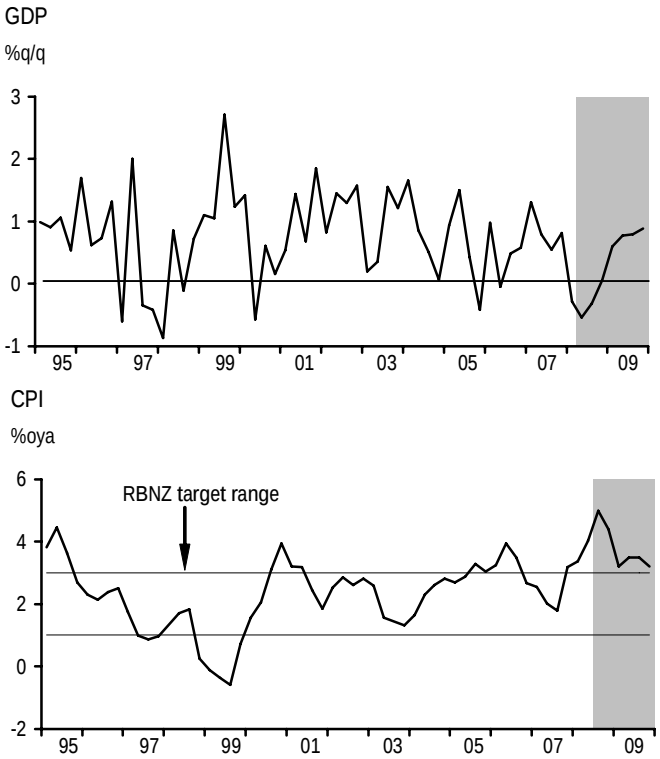
The RBNZ appears prepared to lower its policy rate significantly, although at a steady pace so as to not destabilize the economy or financial markets. It has acknowledged that there is ample scope for a projected easing in interest rates, given that real interest rates in New Zealand are among the highest in the developed world. We expect another three 25bp cuts this year—in September, October, and December (there is no scheduled policy meeting in November) and further rate cuts in 2009. We forecast the OCR at 6.25% by mid-2009, but how quickly the RBNZ lowers the cash rate will depend on how the economy responds to policy changes. The desire to avoid an inflationary plunge in NZD minimizes the chance of a 50bp cut.

Recession to be shallow and short-lived

Economic momentum in New Zealand has stalled. Retail spending is at its weakest since 1991, consumer confidence is at a 17-year low, business confidence has collapsed, and house sales have plummeted to near 16-year lows. Elevated export prices, however, and the government's expansionary fiscal policy, have prevented a sharper downturn.

The economy contracted 0.3%q/q in 1Q. We expect another two quarters of GDP contraction in 2Q and 3Q, and for the economy to stagnate in the final quarter of the year. The last time the Kiwi economy endured successive quarters of negative growth was at the end of 1997 and in early 1998; this was a relatively mild recession. The recession we forecast in 2008 also should be shallow and short-lived.

Our forecast calls for GDP growth to recover to 1.5% in 2009 thanks mainly to the forthcoming personal income tax cuts, lower interest rates, increased government spending,



less drag from the housing market, and the anticipated positive impact on exports from weaker NZD, which has come under significant selling pressure in recent weeks.

Inflation to get worse before improving

Inflation pressures remain widespread, however. Headline inflation accelerated to an 18-year high of 4%oya in 2Q, well above the RBNZ's 1-3% target range, owing to surging gasoline and food prices. More importantly, nontradable inflation—generated domestically and not influenced by the exchange rate—remained uncomfortably high at 3.4%oya; this remains a key point of focus for RBNZ officials.

The risk is that with nontradable inflation persistently high, despite the significant easing in domestic demand, wage and price setting behavior could change—already elevated inflation expectations are trending higher. The potential for second- and third-round inflation effects to develop is a primary concern for the RBNZ. That said, RBNZ Governor Bollard believes that the bank's current policy of inflation targeting is anchoring inflation expectations and allowing room to accommodate short-term inflation shocks. Monetary policy, he says, should be flexible to deal with unavoidable price shocks, while ensuring that inflation returns to target in the medium term—monetary policy should be "firm enough to ensure that generalized second-

round inflation effects do not take hold." This argues against more aggressive rate cuts.

The RBNZ forecasts inflation to peak at 5%oya in 3Q before returning to target over the medium term; that is, as long as "commodity prices stop rising, inflation expectations remain anchored, and weakening economic activity contributes to an easing in nontradable inflation." Our forecast calls for headline CPI to peak in 4Q at a slightly higher 5.2%oya, with upside risks owing to the recent decline in NZD. The significant price pressures in the pipeline—producer input and output prices spiked 5.6%q/q and 3.5%, respectively, in 2Q—places additional upside risks on our forecast. That said, RBNZ officials will look through elevated inflation readings in coming quarters. The focus for RBNZ officials remains the near-term growth outlook and the medium-term inflation outlook.

Business sentiment still very weak

Employees' ability to demand higher wages in response to high inflation, however, should be limited. Corporate profitability has dwindled amid soaring gasoline prices and tighter credit conditions, meaning that firms will probably shed employees to cut costs as economic momentum slows and become less willing to pay more for existing workers.

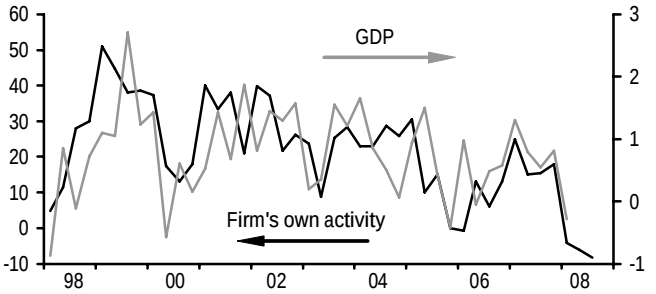
The NBNZ July business confidence survey showed that 43.2% of respondents expect business conditions to deteriorate in the year ahead. Had it not been for heightened speculation of an imminent rate cut, business confidence would likely have fallen further. More worrisome was the sharp drop in firms' own activity expectations from -4.0 to -8.2; this signals a deeper contraction in economic growth in 2Q (chart). Only 16 negative readings in firms' own activity expectations have occurred in the last 20 years. The NBNZ says that five of these "were right at the start of the survey in 1988, as the 1987 crash washed through."

Some relief for struggling consumers

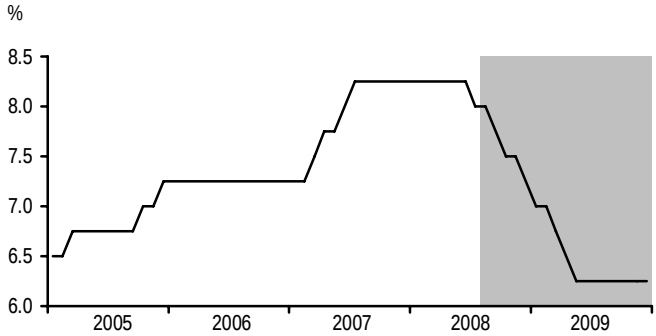
The household sector also is under intense pressure. High interest rates, elevated food and energy prices, and the negative wealth effects from the crumbling housing market have created significant headwinds for consumers. These headwinds have dramatically squeezed consumer spending. In real terms, retail sales sank 1.5%q/q in 2Q, the largest fall on record and the first time since June 1998 that volumes have fallen in two straight quarters—in 1Q volumes fell 1.2%.

While the near-term outlook for retailers is bleak, some improvement in sales can be expected toward year end. Along

NBNZ business outlook survey and GDP growth



RBNZ official cash rate



with lower interest rates, the consumer sector should benefit from additional government spending, lower gasoline prices, and the income tax relief delivered starting October 1. Furthermore, the domestic banks already are passing on the OCR cuts to borrowers, mainly via lowering two-year fixed mortgage rates. Fixed rate loans account for 88% of total loans in New Zealand. Mortgage rates probably will edge lower as the RBNZ's easing cycle continues.

NZD still a key concern for RBNZ

A key risk to the interest rate outlook is a sharp fall in NZD. Expectations of an extended easing cycle, coupled with the rapid deterioration of the economy, have driven a sharp fall in the NZ dollar in recent weeks. NZD has shed 7% against the US dollar since mid year. If NZD falls even more sharply, the inflation profile will deteriorate, leading the RBNZ to refrain from cutting interest rates as steadily and for a long as currently forecast.

Recent NZD weakness is also reflecting broad USD strength and growing speculation that the RBA, Australia's central bank, will begin easing policy next month. Like the RBNZ, the RBA has the luxury of high interest rates as a starting point. With that in mind, the downside for NZD should be limited—NZD should retain some interest rate-derived support in that the OCR will remain high even after the 75bp in rate cuts we forecast this year.