Economic Research
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New Zealand economic update

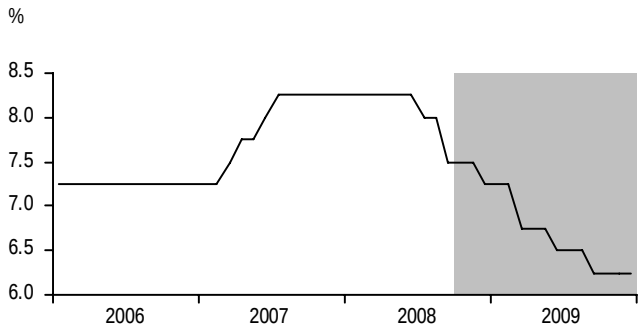
RBNZ cut OCR by 50bp

The RBNZ unexpectedly cut the official cash rate (OCR) by 50bp to 7.5% today (JPMorgan and consensus -25bp). Only one of the 15 market economists surveyed last week by Bloomberg had forecast a 50bp cut. The larger than expected rate cut appears to be mainly owing to the RBNZ's increasing concern over the deteriorating global economic outlook; RBNZ officials' anxiety has risen significantly since the June MPS.

In the statement accompanying the decision to cut the OCR today, the RBNZ highlighted that the outlook for the global economy has "deteriorated further in the wake of continued financial market turmoil". The RBNZ, therefore, deemed it appropriate to lend more weight to the downside risks for New Zealand's economy associated with the deteriorating global economic outlook, alongside increased credit pressures and the correction currently underway in the domestic housing market. On the housing market, the RBNZ forecasts house prices to fall 10% in 2008.

The RBNZ appears to be frontloading policy rate decisions, suggesting that it has "brought forward some of the projected interest rate reduction". Indeed, the Bank remains focused on the near-term downside risks to the growth. Importantly, though, **the RBNZ has not altered the expected overall decline in the key policy rate.**

New Zealand: RBNZ official cash rate



We, therefore, maintain our forecast that the OCR will be cut by a further 25bp in October and again December (there is no policy announcement in November), and that the OCR will fall to 6.25% by mid-2009. That said, future policy changes will depend on how the inflation outlook evolves and the path of NZD, which fell sharply after today's announcement. Any further,

significant weakness in NZD would increase the likelihood that the RBNZ will cut the OCR by less than we currently forecast.

The RBNZ forecasts the Kiwi economy to grow just 0.3% this year, in line with our forecast for annual GDP growth of 0.2%. This marked slowdown will be led "primarily by the household sector," which should start to recover in mid-2009 owing to personal income tax cuts (to be delivered from October 1) and lower interest rates. Before then, though, the RBNZ expects that a deeper economic trough will occur. Our forecast calls for the NZ economy to contract 0.5%q/q in 2Q and 0.3%q/q in 3Q, and to stagnate in 4Q.

On inflation, the RBNZ expects that softer economic activity should help rein in inflation pressures in the medium-term. The RBNZ expects headline inflation to peak at 4.9% in 3Q. This forecast is up from 4.7% in the June MPS and still well above the Bank's 1-3% target range, remaining elevated owing to both tradable and non-tradable inflation. No stimulus is expected from the terms of trade, however. In fact, the RBNZ expects the terms of trade to fall sharply in the near-term as import prices continue to rise (mainly owing to falling NZD) and export prices fall.

Looking ahead, according to the RBNZ, "the scale and timing of further official cash rate reductions will depend on signs of declining inflation pressures and on exchange rate adjustments." As already mentioned, our forecast calls for the OCR to fall to 6.25% by mid-2009, below our estimate of the neutral rate of 6.5%. The key risks to this outlook, we believe, are a significant deterioration in the outlook for the global economy and a sharper than expected fall in the NZ dollar, which dropped over one cent against NZD immediately after the announcement. The kiwi currently buys $0.6524.

On the upside, a weaker NZD should help growth recover to 1.5% in 2009, according to our forecasts, as the economy benefits from increased exports, lower interest rates, personal income tax cuts, and increased government spending.