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Westpac Institutional Bank

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March MPS Review: OCR cut 50bp as post-quake insurance

- **The RBNZ reduced the cash rate by 50bps as a measure to prop up confidence and activity through the immediate effects of the devastating Christchurch earthquake.**
- **Post-quake reconstruction will rapidly soak up the economy's spare capacity and add to inflation pressures in coming years.**
- **The RBNZ expects to raise the OCR again quickly through 2012, though the timing will depend on how quickly the rebuild gets under way.**

The Reserve Bank cut the OCR by 50 basis points to 2.50% this morning, as we anticipated. The devastating earthquake in Christchurch on 22 February left the central bank with a dilemma: activity and confidence in an already-weak economy will be dented over the short term, but the eventual reconstruction efforts will seriously test the economy's spare capacity and add to inflation pressures over coming years. In the end, the RBNZ felt that the near-term impact was too great to look through, and opted to provide some temporary relief through lower borrowing rates.

In fact, what was probably most striking about today's Monetary Policy Statement was how explicit it was about the temporary nature of this rate cut. The document noted that: "Lowering the OCR should be regarded as an insurance measure, designed to help offset the negative economic effects of the earthquake until such time as rebuilding – and a recovery in the broader economy – act to draw on the economy's surplus resources."

That rebuilding effort is not expected to be in full swing until next year, with repairs to essential infrastructure starting first. But once it is under way, it will make a significant claim on the nation's resources – far more than was expected out of last September's quake. GDP is expected to grow just 1.3% this year, but to reach a peak growth rate of 5.4% by the end of 2012 (Figure 1). By this time the RBNZ expects that the economy's spare capacity will have been soaked up, a little earlier than previously thought.

That will put the RBNZ under pressure to get interest rates back to a 'neutral' level before long. The RBNZ's 90-day rate projection starts to tick up in December, which is consistent with markets looking forward to a hike in January 2012, followed by at least 150bps of tightening over the course of the next year (Figure 2). However, the timing and pace of rate hikes will depend on how quickly the rebuild gets under way. Like everyone else, the RBNZ is working from limited information at the moment, so that profile could be reassessed in either direction over the next few months.

Figure 1: GDP forecasts

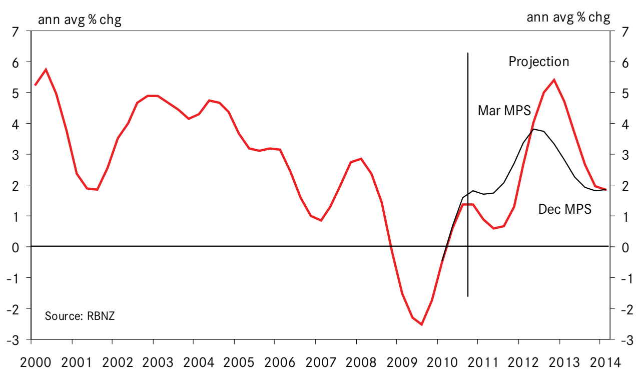
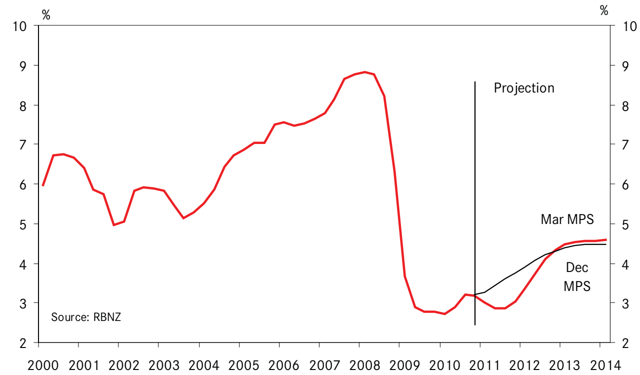


Figure 2: 90-day interest rate



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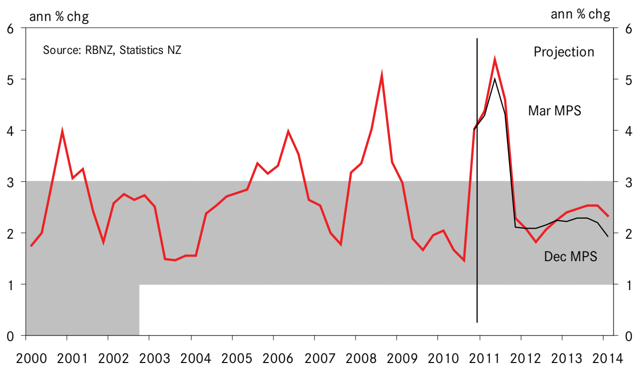
The RBNZ emphasised that today's rate cut was not just temporary, but most likely a one-off. The economy clearly softened through 2010 – the MPS did not provide detailed quarterly forecasts, but hinted that Q4 GDP was estimated to be around flat, following Q3's 0.2% contraction. But high commodity prices are set to provide a major boost to export income, and there was a growing body of evidence that domestic activity had picked up in the weeks before the quake struck. So while it's perhaps a moot point, it seems that were it not for the earthquake, it's unlikely that a rate cut would have been considered. What's more, softer data in the next few months will not necessarily scare the RBNZ into further cuts – with today's move it has already braced itself for some softer confidence and activity data in the near term.

With so much focus on the immediate impact of the earthquake, there is a risk that the RBNZ's inflation message gets lost in the mix – in fact, inflation was not mentioned in the media release at all. (A word count of the MPS finds that 'earthquake' outnumbers 'inflation' by about 2:1, which seems reasonable in the circumstances.) And it is worth noting that the faster tightening profile for 2012 does not completely offset the inflationary effects of easier policy today and the increased pressure on resources as the rebuild begins. Beyond the GST-induced spike in annual inflation this year, the RBNZ now expects inflation to peak at 2.5% in 2013, compared to a 2.3% peak in its December projections (Figure 3).

Figure 3: Inflation forecasts



We suspect that inflation could reach higher than this, given the global emergence of higher inflation, soaring fuel prices, and the as-yet-unknown capacity of the building industry to meet the demands of the reconstruction effort. But by the standard of its own projections, it would be hard to accuse the RBNZ of abdicating its inflation-targeting duties in the face of a crisis. A 2.5% peak is well within the bounds of the Policy Targets Agreement, which requires an average of 1-3% over the medium term. Obviously, it leaves less room to absorb any upside surprises on inflation, but the RBNZ has already expressed a willingness to lift interest rates quickly once it becomes apparent that inflation pressures are returning.

Market implications

The 50bps cut was largely but not fully anticipated by financial markets, as there was a range of views beforehand about what the RBNZ would or even should do. The New Zealand dollar fell 40pts after the statement, but clawed back half of this to end the day around 0.7380. The two-year swap rate fell by 9bps to 3.29% over the day, but longer-term rates moved by less, leaving a steeper yield curve.

We generally agree with the RBNZ's assessment of the economy, and with its projection that the OCR will rise quickly once the rebuild begins. At the margin, we'd suggest an even steeper tightening profile beyond 2012 – our long-running view is that the 'neutral' cash rate is not as low as the 4.5% or so that the RBNZ is assuming, but that's a question that will take some time to resolve.

Neither we nor, we suspect, the RBNZ would regard today's OCR cut as a merely symbolic move – it will provide some genuine relief to borrowers across the country, where knock-on effects from the Christchurch quake could be felt. But its temporary nature means that borrowers will need to be careful to make the most of it. The window of opportunity for sitting on floating rates, before jumping into a fixed term, has probably shortened after today's statement.

RBNZ media release

The Reserve Bank today reduced the Official Cash Rate (OCR) by 50 basis points to 2.5 percent.

Reserve Bank Governor Alan Bollard said: "The Reserve Bank extends its sympathies to all those affected by the Christchurch earthquake. Our condolences go especially to those who have lost family, friends and colleagues.

"The earthquake has caused substantial damage to property and buildings, and immense disruption to business activity. While it is difficult to know exactly how large or long-lasting these effects will be, it is clear that economic activity, most certainly in Christchurch but also nationwide, will be negatively impacted. Business and consumer confidence has almost certainly deteriorated.

"Even before the earthquake, GDP growth was much weaker than expected through the second half of 2010. Households have continued to be very cautious, with retail spending volumes and residential investment both declining. The export sector has benefited from very high commodity prices, however, farmers have focused on repaying debt rather than increasing spending. Also the early summer drought constrained farm output through this time. Signs that the economy was beginning to recover early in 2011 have been more than offset by the Christchurch earthquake.

“In putting together the forecasts underlying this Monetary Policy Statement, the Bank has had to make many important assumptions based on limited information. Over the coming weeks and months, these judgments will be tested as new information comes to hand. For now, GDP growth is projected to be quite weak through the first half of the year. This will gradually build up to a very large reconstruction programme by 2012 that will last for some years and contribute to a period of relatively strong activity.

“Future monetary policy adjustments will be guided by emerging economic data. We expect that the current monetary policy accommodation will need to be removed once the rebuilding phase materialises. This will take some time. For now we have acted pre-emptively in reducing the OCR to lessen the economic impact of the earthquake and guard against the risk of this impact becoming especially severe.”

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