Thinking the Unthinkable: the Chance of a Cut in the Official Cash Rate

New Zealand Fixed Income Monthly Commentary

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- Once again, global factors drove NZ interest rates over the course of August: the hope of ECB action to address the Europe crisis pushing rates up; and the hint of further US Federal Reserve action to simulate the US economy pushing them down.

- In this note, we think the unthinkable and consider the chance of an Official Cash Rate (OCR) cut from the RBNZ.

- While our central expectation is that the OCR remains unchanged in coming months, we conclude there is nothing sacred about a 2.5% OCR.

- A further significant deterioration in China and Australia could tip the case for an OCR cut from the RBNZ. However, in the meantime we expect the OCR to remain on hold, especially as a new Governor settles into the job.

The importance of global developments

The Reserve Bank of New Zealand last moved the OCR in March 2011, some 17 months ago. Since then, the direction of long-term interest rates in New Zealand has been dictated largely by global developments, ranging from the US sovereign downgrade, the closure of global funding markets, the European sovereign crisis, and quantitative easing by the US Federal Reserve.

The importance of these global factors was once again illustrated over the course of August.

The first half of the month saw a sharp rise in yields following the comments from ECB President, Mario Draghi, that the central bank was willing to do “whatever it takes” within its mandate to address the European crisis. Then in the second half of August, global interest rates fell back towards their lows: first as doubts re-emerged about the ability of European authorities to act decisively; then as US Federal Reserve Chairman, Ben Bernanke, highlighted that the US recovery had been “far from satisfactory”, hinting further action to keep US interest rates lower for longer.

Thinking the unthinkable

Throughout these ebbs and flows in global news, the market has only briefly toyed with the idea that the RBNZ may cut the OCR in the face of these developments. It has almost been unthinkable.

Instead, local economists have continued to push out the time at which they expect the RBNZ to start the eventual tightening cycle. Back in March 2011, economists picked the turn of the year. But now some have pushed their expectations out as far as 2014 – although the consensus view remains mid 2013.

While it is not our central expectation that the RBNZ will cut the OCR in coming months, we believe that it is timely to think the unthinkable. In this note, we explore afresh the case for a rate cut. So here it is:

- The fact **that annual inflation at 1%** is at the bottom of the target range certainly provides the space for the RBNZ to contemplate a cut. So does the fact that inflation expectations have drifted comfortably back to the middle of the target range following their post GST blip.

- Moreover, the emergence of inflation from capacity pressures does not appear imminent, especially when you consider that **unemployment has remained stubbornly high** in the post GFC recovery. The IT and Christchurch construction sectors aside, it is not an environment where workers can easily bargain a wage increase or that businesses can easily pass on higher costs.

- Up until recently, NZ has benefited from the resilience of China and our closest trading partner, Australia, experiencing the wealth effects of a resources boom. However, the resources boom looks to be fading noticeably, as evidenced by **slower Chinese economic indicators**, a sharp fall in iron ore prices, and the cancellation of some of the largest **Australian mining projects** in the pipeline. This increases the chance of an interest rate cut from the RBA.

- Over patches of 2011 and 2012, the RBNZ has noted its discomfort about a **high exchange rate** not reflecting our local economic fundamentals. To the extent that the US and others continue down the path of quantitative easing, this should devalue their currencies, seeing the NZD strengthen in relative terms. Furthermore, a slowdown in Australia could see the NZD/AUD significantly higher, hurting those exporters that up until now have benefited from a favourable NZD/AUD exchange rate.

- Finally, the NZ government continues to tighten its belt with public sector job cuts, running a **tight fiscal policy** to ensure that NZ government debt levels keep off the radar of rating agencies.

This combination of weakening trading partner growth, a high exchange rate and tight fiscal policy is a classic prescription for a loose monetary policy, potentially making the case for an OCR cut from 2.50%.

Accepted wisdom would point to robust business confidence, the housing market and the Canterbury rebuild as reasons not to cut interest rates from here. However, these issues can be addressed in turn:

- Whilst **business confidence** points to moderate economic growth in the year ahead, this has not been a reliable indicator since the GFC, and has so far not translated through to jobs growth and capacity pressures. Renewed weakness in China and Australia may dampen remaining confidence and delay business plans to invest.

- The recovery in the **housing market** is still in its very early stages, and certainly far too early to need to worry the RBNZ. Every housing downturn is followed by a recovery. The recent uptick in house prices is not unusual. Importantly, house price inflation is still localised to where there is specific supply shortages – central and eastern suburbs of Auckland, and areas surrounding Christchurch. The housing market recovery is not widespread, in part because households are more cautious post GFC and many are still using low interest rates to pay down debt and reduce leverage.

- Two years after the first of the **Christchurch earthquakes**, demolition is in full swing, plans for the rebuild are taking shape, and delays from bureaucracy are being addressed. But, for monetary policy, the evidence so far is that the rebuild is being spread over a long enough period to reduce the threat that it will spark inflation pressures from a scrabble for resources over a narrow window of time.

Conclusion

To be clear, it is not our central expectation that the RBNZ will cut the OCR in coming months. Equally, it is important not to rule this out as a possible scenario with a material probability. There is nothing sacred about 2.5% that means the OCR cannot be cut further. The US, UK, Europe and Japan already illustrate this point, with official rates near zero.

But the RBNZ needs to use it ammunition wisely. In our view, the case for the RBNZ to cut the OCR is not yet compelling on purely domestic grounds. The new Governor will also want time to settle into the job to make his judgement.

As we have seen through 2011 and 2012, global factors may turn out to be the determining influence for New Zealand interest rates. We will be watching developments in China and Australia closely. The path of the NZD exchange rate and NZ commodity prices will also be critical in any judgement to move the OCR.

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