



Data source: Bloomberg, SFE Corporation

Reserve Bank reacts to quake

The Reserve Bank cut the official cash rate 50 basis points, to 2.5%, in response to last month's earthquake in Canterbury. With rebuilding activity in Christchurch not expected to kick into gear until 2012, rates are unlikely to rise before the final quarter of 2011.

February's earthquake was a major event for both the region and New Zealand as a whole, and the ramifications of the earthquake on national economic activity were at the forefront of the Reserve Bank's statement. The Bank stated that it expects confidence to be weaker during the coming months. The drop in demand associated with the lower confidence levels, combined with the weak starting point for the economy, convinced the Bank that the economy needed some additional support during 2011.

The Reserve Bank expects construction activity to rise sharply in 2012, putting upward pressure on inflation and leading to a sharp increase in the official cash rate by the Bank. The Bank's forecasts show a 130 basis point lift in 90-day bill rates during 2012.

It is unsurprising that the Bank's outlook for the economy has shifted following this disaster. However, economic theory is unclear on what central banks should do following such a disaster. The Bank will need to be vigilant to ensure that it neither fails its inflation mandate or unnecessarily depresses economic activity.

Balancing these goals, while remembering that inflation remains the primary target, is difficult. However, as economic data is released throughout the first half of the year we will get a better handle of the effect of the earthquake - and therefore of how Reserve Bank policy will change. At present, December 2011 or January 2012 give a reasonable estimate of when to expect the first rate rise in the next tightening cycle.