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Assessing the economic and political environment in New Zealand

13 March 2014 | Confidential to HUGO members

A 4.5% OCR by early 2016 — then some more?

The immediate official cash rate (OCR) lift is 0.25 percentage points to 2.75% but the Reserve Bank adds: "The Bank's assessment is that the OCR will need to rise by about 2 percentage points (to 4.5%) over the next two years for inflation to settle around that target (2%)." But is that all? The Bank's 5.3% projection for the 90-day interest rate adds another 0.5 percentage points by March 2017.

That matches Hugo's assessment that the "neutral" OCR rate is 4.5%, as also indicated by assistant governor John McDermott in a recent speech. It is common for the OCR to swing past neutral in a tightening cycle, which is consistent with the Bank's 90-day rate projection. And if 4.5% is "neutral", that underlines just how "accommodating" the OCR has been since 2009. The 0.50 percentage point cut in March 2013 was an emergency response to the second Christchurch earthquake.

The Bank expects annual CPI inflation to reach its midpoint target of 2% by June this year.

The Bank paints a bullish picture of the New Zealand economy in this morning's quarterly monetary policy statement:

—gradually increasing growth in trading partners (4.2% for 2014 and 2016), including a recovery in Australia, though with significant variations elsewhere and a caution about China's "rapid increase in debt" which raises a risk of "financial disruption";

—"extremely high" prices for export commodities (which it projects to ease but not fall drastically); strong growth in construction, both in Christchurch and, increasingly, elsewhere, which is feeding strong manufacturing growth;

—strong residential and business investment through the next two years, adding a wage push;

—a big rise in net immigration; it should ease "gradually" but "remain above average through the projection period";

—unemployment falling to 4.9% through 2015 and 2016 on a continued high participation rate; and

—"very high confidence among consumers and businesses", with increasing hiring and investment (though investment is projected to ease after 2014).

Bad news: a very high exchange rate which is "not sustainable in the long run" but which the Bank expects to ease only gently from 78.4 to 75.3 on the trade-weighted index (TWI) through to March 2017; the balance of payments current account deficit is projected to climb to 5.6% of GDP by 2016.

Good news: the loan-to-value ratio limit has contributed to an easing in house price inflation, on which "high household debt" and mortgage rate increases are expected to weigh over the next two years. Bad news: the household saving rate is projected to stay negative through the next two years.

The Bank defends today's OCR rise against critics who argued for a hold by insisting that its aim is sustainable GDP growth, that is, growth within capacity limits. It projects output to exceed capacity through the next two years (which is inflationary). Its GDP projections are for 3.4% in 2014 and then 2.4% through 2015 and 2016.

That in turn reflects a wide disparity between domestic (non-tradables) and import (tradables) inflation. Non-tradables inflation is projected in the 3%-4% range through the next two years and tradeables inflation to be negative. How long this disparity is sustainable is a matter of conjecture.

There is also a question over how consumers and businesses will react. The last tightening cycle began in 2003 and ended in 2008. Note that inflationary expectations in the Bank's own survey are for 2.3% over the next year.

Text finalised 13 March 2014
Contact: hugo@thehugogroup.com.