Flashnote

HSBC
Global Research

Macro
New Zealand Economics

The RBNZ Observer

On hold, with a longer pause now expected

- **Having delivered 100bp of hikes and with dairy prices falling, the RBNZ is expected to hold steady next week**
- **Timely indicators of business and consumer sentiment have stepped back from high levels, although inward migration remains strong and the Canterbury rebuild is on-going**
- **Given some easing in conditions and the dairy price fall, we now expect the RBNZ to be on hold for the rest of this year, with the next hike expected in Q1 2015 (previously Q4 2014)**

The RBNZ has time on its side

The rate hikes are over for now. With 100bps of interest rate hikes delivered between March and July, the RBNZ made it clear at the last meeting that it is on hold for the time being. And recent activity indicators suggest that some of the shine has been taken off the economy's boom – meaning an extended pause from the RBNZ looks prudent.

With a no-change decision widely anticipated, more interest will be focused on the tone of the Monetary Policy Statement and the accompanying forecasts. Over the past few months, prices for key export commodities have continued to decline, impacting incomes. At the same time, business and consumer sentiment have softened, as has the housing market – all suggesting that higher interest rates are already restraining activity.

While the RBNZ's forecasts may be a little softer that those published in June, they will almost certainly be more hawkish than current market pricing. In June, the RBNZ's forecasts implied an OCR of around 4.5% at end-2015, whereas market pricing has now fallen to imply an OCR of only around 3.75% by that point.

We remain optimistic about New Zealand's growth prospects. Even though indicators have moderated a little recently, they remain at healthy levels overall and we still expect the economy to grow by +3.5% over 2014 and +3.0% over 2015. With growth continuing to exceed potential, the economy's spare capacity will likely diminish further and more inflationary pressure is expected to be generated.

The key judgment for the RBNZ is just how much inflation will be generated and when. So far, despite strong economic growth, inflation has been well-contained. The same is true of wages and forward-looking indicators of firms' pricing intentions. With the inflation outlook still benign, the RBNZ has time on its side. We now expect it to remain on hold for the rest of 2014, before resuming a hiking stance in early 2015.

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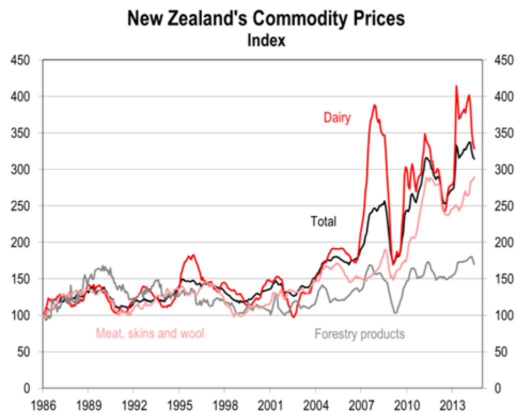
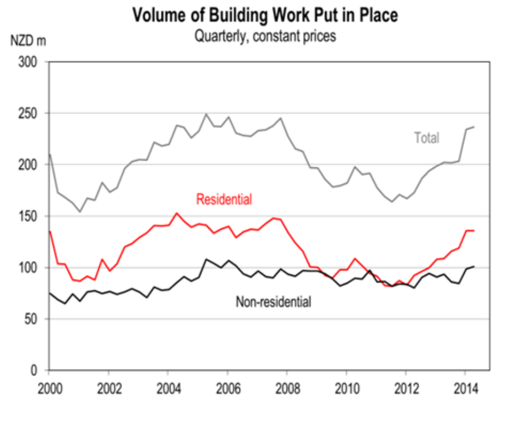
1. Dairy prices have fallen sharply



Source: Thomson Reuters Datastream

2. Construction activity is a major driver of growth



Source: Statistics New Zealand

NZ's economic outlook less rosy, but still positive

Much has been made of the sharp decline in dairy prices over the past six months (Chart 1). Since February, the GlobalDairyTrade price index has fallen by -43%. That will reduce farming incomes and will impact the RBNZ's forecast (the June Monetary Policy Statement assumed a -27% fall in dairy prices). However, we believe much of the swing in dairy prices is being driven by an inventory cycle in China, which may prove to be a temporary effect. Looking beyond the inventory cycle, we expect medium-term demand for New Zealand's commodity exports will continue to grow strongly as developing Asia's incomes and middle classes grow (see Bloxham, P. and Smith, D. (2014) *New Zealand Digest: Milk story may be turning sour*, 19 August).

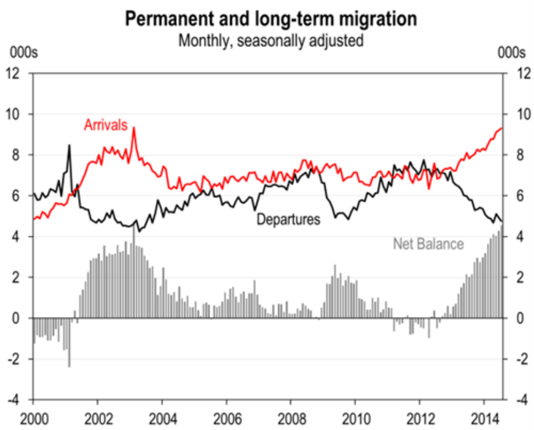
But, importantly, New Zealand's economic growth is being driven by more than just a bumper dairy season. In particular, the construction sector is booming due to the Canterbury rebuild and strong home building demand in Auckland (Chart 2). This is expected to persist and to support growth.

Still, recent data suggest the pace of expansion will start to slow from the 4%-plus annual pace seen over recent quarters. In particular, business confidence has fallen, influenced by lower dairy prices and, potentially, the upcoming general election (Chart 3). Consumer confidence has also eased, although it remains strong and Q2 retail sales figures were healthy.

3. Confidence has fallen back from high levels

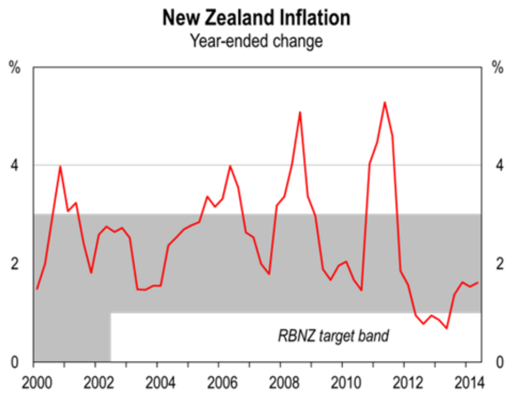
Source: Statistics New Zealand, Thomson Reuters Datastream, HSBC

4. Net migration continues to surpass expectations



Source: Statistics New Zealand

5. Inflation remains in the lower half of the target band



Source: Statistics New Zealand

6. Business pricing intentions are not high

Source: ANZ

One factor that will partly offset some of these softer indicators is migration. Net migration gains continue to surpass expectations and the RBNZ will most likely increase its migration forecasts once again (Chart 4). The RBNZ has made clear that it sees stronger migration as an inflationary factor, adding to domestic demand and exacerbating housing pressures in Auckland and Canterbury.

Moderating growth and benign inflation allow room for pause

Given moderating activity indicators, a housing market that is less of a pressing concern and lower commodity prices, a pause in the tightening cycle is appropriate. That is especially true given the high degree of uncertainty about how exactly the previous hikes will impact the economy. Fortunately, the inflation outlook gives the RBNZ some breathing room.

Despite the New Zealand economy's strong performance over the past year or so, inflation remains well-contained, at +1.6% y-o-y in Q2 (Chart 5). The risk of a sharp pick-up in the near future looks low, given the strong NZD, soft wage growth and business pricing intentions that are certainly not high by historical standards (Chart 6). So far, New Zealand's economy has perhaps exhibited more spare capacity than expected. But with growth set to continue outpacing potential over the next couple of years, we do expect inflation will rise over time.

For that reason, we believe the tightening cycle is not over but rather on hold. The OCR is still well below neutral – estimated to be around 4.5% – and will most likely need to be lifted towards that level next year and into 2016 as the economy tightens further. We now expect the next rate hike to be in Q1 2015 (previously Q4 2014), with the cash rate expected to get to 4.25% by end-2015 (previously 4.50%).

1. HSBC's main forecasts for New Zealand

	Year-average (%)			Year-ended (%)							
	2013	2014f	2015f	Q114	Q214f	Q314f	Q414f	Q115f	Q215f	Q315f	Q415f
GDP	2.8	3.5	3.0	3.8	4.0	3.4	2.9	2.7	2.7	3.1	3.4
CPI*	1.1	1.7	2.5	1.5	1.6	1.4	2.1	2.4	2.7	2.6	2.3
Unemployment rate	6.2	5.7	5.1	6.0	5.8	5.5	5.3	5.1	5.1	4.9	4.9
NZD/USD** ^	0.82	0.87	0.88	0.87	0.87	0.86	0.87	0.88	0.88	0.88	0.88
Cash rate (new)^	2.50	3.50	4.25	2.75	3.25	3.50	3.50	3.75	4.00	4.00	4.25
Cash rate (previous)^	2.50	3.75	4.50	2.75	3.25	3.50	3.75	4.00	4.25	4.25	4.50
Market Pricing											
OIS Implied^	NA	3.53	3.75	NA	NA	3.50	3.53	3.55	3.62	3.70	3.75

Source: HSBC estimates; **NZD forecasts detailed in 'Currency Outlook: July 2014' ^end-period

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