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Economic Research note

RBNZ now expected to hike cash rate to 8.25% next week

- **The RBNZ is likely to consider July an opportune time to hike the OCR to a fresh record high of 8.25%**
- **Surging dairy prices, a relentless housing market, and fiscal largesse argue for further tightening**
- **This week's final piece of the RBNZ policy puzzle—nontradables[1] inflation—was too strong to dismiss**

The RBNZ's war on inflation is not over, and another OCR tightening now appears warranted. In a change of forecast, JPMorgan expects the RBNZ to raise the OCR 25bp to a record high 8.25% on Thursday. Previously, we suggested that there was a 30% probability of a July rate hike, but we now see a 65% chance: the four criteria that we believed had to be satisfied ahead of the July policy decision for the RBNZ to tighten have been met, if not surpassed.

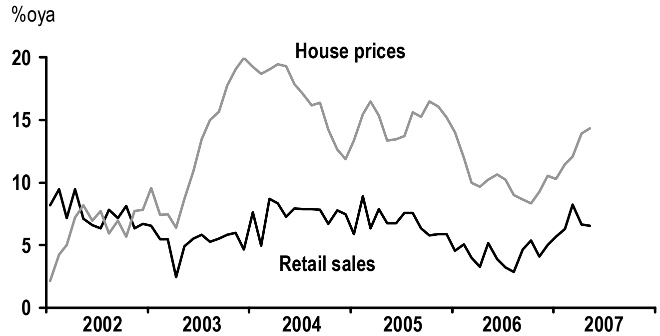
Hitherto, RBNZ officials' resolve to pull the housing market into line, frustrations over expansionary fiscal policy, and concerns about the passthrough effects from surging dairy prices have fueled the central bank's willingness to tighten policy. Already, the RBNZ has raised the OCR three times this year in order to encourage a lower inflation trajectory, and hawkish public commentary indicates that officials have sufficient determination to go further. The June Monetary Policy Statement (MPS) stated, "a sustained period of slower growth in domestic activity will be required to alleviate inflation pressures," with Governor Bollard adding, "the risks to domestic activity appear to remain on the upside."

Key criteria surpassed for RBNZ rate hike

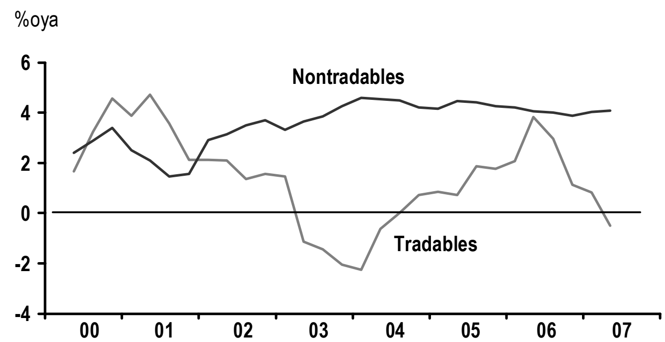
In our last RBNZ research note (see "RBNZ puts heat on inflation with scorched earth policy" *GDW,* Jun 29), we outlined four key criteria that would need to be satisfied in order for the RBNZ to tighten. Three of the four rate hike criteria—still-elevated business confidence, stubbornly buoyant retail spending, and rising house prices—argue for another rate hike but, on their own, are not sufficient to push the RBNZ across the line. However, the most important of the four criteria for a tightening—still-elevated nontradables inflation—was satisfied this week, when the annual rate printed at an unexpectedly high 4.1%oya; it has now remained around the 4% level for the past four years.

1. Nontradables are goods and services that do not face foreign competition.

Retail sales and house prices



CPI: tradables and nontradables



The four data criteria we set, in order of importance, are:

- **Nontradables inflation.** Again printing above expectations, nontradables inflation was 1.1%q/q in 2Q, and remained above the psychological 4% level in annual terms. Despite the fact that much of the momentum in 2Q inflation was driven by a jump in gasoline prices (up 8%q/q) and a surge in electricity costs (up 3%), the chunky quarterly outcome and unsatisfactorily high annual growth rate give the hawks within the RBNZ more than enough to squawk about. The likely second-round effects of rising gasoline, electricity, and food prices mean that the RBNZ possibly has more work to do, even though previous tightening is still working its way through the economy.
- **NZIER Quarterly Survey of Business Opinion.** Falling in line with expectations, general business confidence dropped to -37 in 2Q, down from -15 in 1Q. The growing pessimism recorded in the survey was "widespread," according to the NZIER. All key indicators of capacity usage and inflation (utilization rates, pricing, cost intentions, and difficulty finding labor) fell over the quarter and point to lower inflation pressure in the pipeline. That said, the levels of the key indicators remain uncomfortably high, and continue to point to the need for vigilance on the inflation outlook. Consumer confidence also fell, but the massive income payout to dairy farmers

and a stable labor market are putting a cushion under consumption growth.

- **House prices.** Home construction and sales activity are showing signs of buckling, yet house prices remain elevated. According to the June REINZ report, the median house price fell to NZ$347,500 from NZ$350,000. This contrasted with the Quotable Value (QV) series, which reported that house prices rose 12.2%oya calculated over the three months to June, up from 11.1% previously. Both reports showed a reduction in trading activity, and suggested that the soaring housing market has hit an air pocket. The RBNZ, however, which focuses primarily on the QV house price series, will want to make sure that the reduction in activity is not just related to cold weather, and is in fact a turn in the market.
- **Retail sales.** Retail spending unexpectedly bounced back in May, rising a healthy 1.2%m/m after falling 1.2% in April. Core retailing, which excludes vehicle-related industries, posted a chunky 0.8%m/m gain. The message from the retail data was mixed, though, as the major gains in retailing from food, furniture, and vehicle sales were partially offset by sharp falls in department store and clothing retailing. That said, the report showed that sales have returned to the March level, which was when the RBNZ was particularly concerned about persistently strong consumption growth.

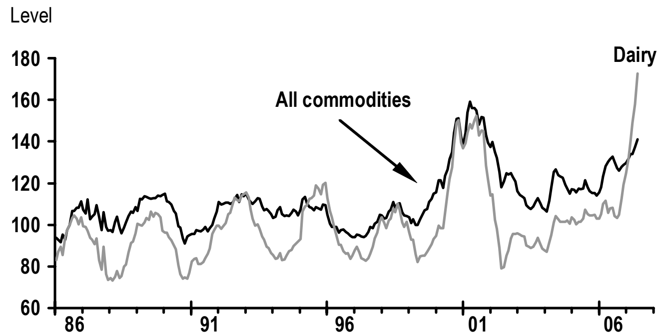
The cracks beneath the surface in some of the data (i.e., falling housing activity rather than prices) will not be enough to offset central bank concerns over still-elevated nontradables inflation. Indeed, the accumulation of solid (albeit softening) economic indicators, and the RBNZ's inability to drag nontradables inflation below 4%oya, make it difficult for Governor Bollard to dismiss the need for a further 25bp rate hike next week.

RBNZ's assertive reaction function

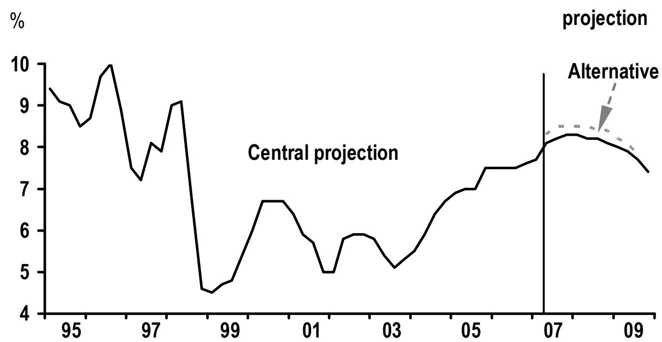
Previously, JPMorgan believed that the RBNZ had time to assess the full impact of this year's three OCR rate hikes in March, April, and June. The RBNZ's assertiveness in responding to upside surprises on key economic data, though, has intensified this year, owing to frustration among officials over their inability to drag inflation lower and the housing market back into line. RBNZ officials seem to have become more comfortable with the risk of overtightening in an effort to end a tightening cycle that already has spanned four years—the RBNZ started tightening policy in January 2004, and has since raised the cash rate 12 times.

The expected 13th tightening next week will extend the Land of the Long Dark Cloud's interest rate advantage over other major currencies. New Zealand already has one of the highest cash rates in the developed world, and a further tightening will only increase the high-yielding allure of the Kiwi dollar. At nearly US$0.80, however, NZD will continue to dent the competitiveness of the nation's exporters—those outside the dairy industry, that is.

ANZ commodity price index - in NZD



RBNZ MPS: 90 day interest rate track



Beyond July, risk of another hike

The RBNZ's hawkish June MPS hinted that further tightening might be required. With this in mind, and, even after assuming that the RBNZ will tighten now, there is a growing risk of another tightening in September. Further tightening depends on whether the key data points mentioned above show decisive signs of turning in the third quarter.

The RBNZ's scenario analysis for short-term market interest rates in the latest MPS showed a higher "alternative scenario" that predicted a 90-day interest rate track peaking at 8.5% in 4Q, well above the 8.3% in the central projection. The central bank's alternative scenario was based on an economy that is "more stretched," in which "world dairy prices prove to be higher for longer" than the central projection. These factors appear to be playing out, with 1Q GDP coming in ahead of RBNZ expectations (at 1.0%q/q versus a 0.8% forecast), capacity utilization levels remaining elevated, nontradables inflation still holding at uncomfortably high levels, and dairy prices continuing to soar.