Macro
New Zealand Economics

The RBNZ Observer

Expected to hike rates next week

- **New Zealand's economy continues to pick up strongly, supported by post-earthquake reconstruction, elevated export prices and rising household spending**
- **With demand booming and the economy already operating at capacity, the RBNZ should raise interest rates to keep inflation contained**
- **We expect the RBNZ to be the first developed world central bank to lift rates in this cycle, raising the cash rate by 25 basis points to 2.75% next week**

Interest rates should start to head towards neutral

New Zealand's economy is at the beginning of a boom and interest rates should be increased from their current low levels to keep inflation contained. We expect the hiking phase to begin next week, with the RBNZ likely to raise rates by 25 basis points to 2.75%. This would make the RBNZ the first developed world central bank to lift rates in this cycle.

The three key drivers of growth remain in place, supporting strong growth in New Zealand.

First, post-earthquake construction continues to ramp up and is expected to support growth for a number of years. Second, New Zealand's export prices remain at high levels, as strong demand from China provides a substantial boost. Third, household spending has picked up, supported by the run-up in housing prices over the past year or so and low interest rates. Despite a cooling in the housing market in recent months, the fundamental factors underpinning housing also remain in place, with strong migration inflows continuing against a backdrop of weak supply. Consumer confidence is at the highest level since 2007, suggesting spending will likely pick up further in coming months.

These factors are set to persist for some time and underpin further strong growth in an economy that is already operating at capacity. Business surveys imply annual GDP growth in excess of 4.0%, a rate that is well above the economy's estimated potential growth rate of around 2.5%. Cost pressures are expected to build.

As a result, the RBNZ should start to normalise interest rate settings if it is to achieve its inflation goals. We expect the RBNZ to hike rates by 100 basis points through 2014 as it seeks to manage New Zealand's boom.

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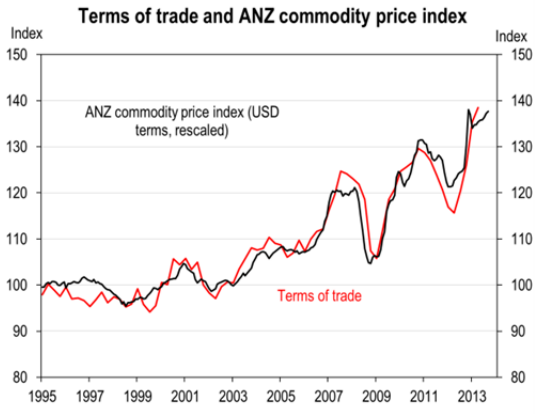
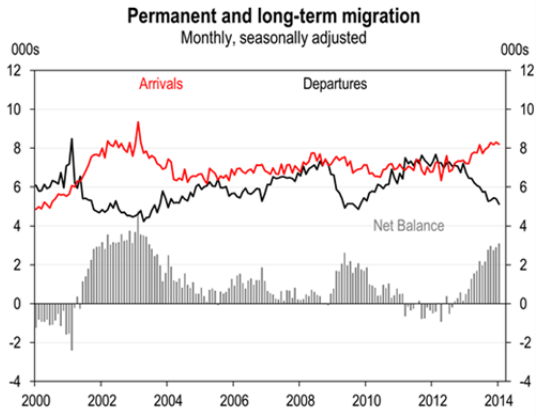
1. The terms of trade are at a 40-year high



Source: Statistics New Zealand, Thompson Reuters DataStream

2. Migration should support the housing market



Source: Statistics New Zealand

New Zealand is beginning to boom

Recent indicators for New Zealand continue to paint a picture of an economy at the beginning of a boom.

The external sector is providing a significant boost, as New Zealand's terms of trade posted a new 40-year high (Chart 1). China's demand for dairy products has picked up strongly over the past few years, as a growing middle class shift their diet towards 'finer foods'. As a result, dairy prices have surged and are providing a substantial boost to New Zealand incomes, while exports to China have picked up substantially. A similar story applies to meat and forestry products.

At the same time, domestic demand is being boosted by post-earthquake reconstruction activity, which is continuing to ramp up. With the total rebuild estimated to be around 20% of GDP, this will be an ongoing driver of growth for a number of years.

A strong housing market has been a further factor supporting strong growth, as low interest rates and supply-side restrictions have driven strong growth in house prices. House price inflation has begun to moderate in recent months, as higher market mortgage rates and recent loan-to-value ratio restrictions have cooled the market. However, with inward migration tracking close to record levels, interest rates still low and little movement on the supply front, the market is likely to remain well supported (Chart 2).

In addition, activity in the wider household sector is beginning to pick up strongly. Consumer confidence has risen to the highest level since 2007 (Chart 3). Rising asset prices coupled with an improving labour market has the New Zealand consumer on the verge of a spending spree. Firms hiring intentions are also at record highs, with the boost provided by a stronger labour market likely to continue (Chart 4).

Collecting these factors together suggests that demand is booming. The business surveys are also consistent with the notion that the economy is already booming. Given that the economy is already operating at capacity, we expect cost pressures could increase quickly if left unchecked. Firms are already signalling the potential for this, with pricing intentions continuing to rise in recent months.

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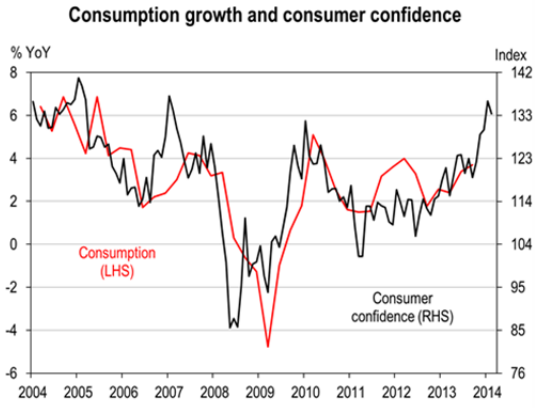
3. Consumption growth set to strengthen



Source: Statistics New Zealand, Thompson Reuters DataStream

4. Firms are planning to boost hiring

Source: Statistics New Zealand, Thompson Reuters DataStream

Careful not to get behind the curve

As a result, the RBNZ should begin to raise interest rates if it is to keep medium-term inflation in check. The RBNZ's January statement opened the door for a March hike, and we expect the RBNZ to follow through with a 25bp increase in the official cash rate to 2.75% at next week's meeting.

Two factors are likely to temper the RBNZ's view on the outlook – although these are unlikely to be enough to see it hold off rate hikes. First, global risks have heightened in recent weeks, as adverse weather has clouded the outlook for Western economies, momentum in China looks to be slowing, and developments in the Ukraine have raised geopolitical risks. However, despite these developments, global demand for New Zealand's exports has continued to forge ahead, as evidenced by the record prices that exporters are receiving.

Second, is the elevated NZD, which has held up a bit more than the RBNZ had expected when tit issued its last set of forecasts in December. A strong currency could act as a key headwind for trade-exposed sectors of the economy. However, the NZD is also playing the role of shock absorber, making way for post-earthquake reconstruction and spreading the benefits of high export prices to the broader population. Suffice to say, the strong domestic growth story likely justifies the higher-than-expected NZD.

The RBNZ will also publish a full set of forecasts with next week's interest rate decision. As usual, the focus will be on the RBNZ's outlook for 90-day interest rates. As well as factoring in a 25bp hike on the day, we expect the RBNZ will raise the medium-term profile for the 90-day rate. The economy looks to have greater momentum than the RBNZ was assuming in December, while underlying price pressures also looking stronger, factors that are likely to offset the slightly stronger-than-expected NZD and lead to a higher forecast interest rate path.

Given this forecast interest rate path, we expect the language in the accompanying statement to signal further rate hikes are likely in coming meetings. Overall, we expect the RBNZ will need to deliver 100 basis points of hikes in 2014 to contain New Zealand's boom.

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Bottom line

The New Zealand economy continues to pick up strongly, supported by post-earthquake reconstruction, high export prices and strong household spending.

With demand booming and the economy already operating at capacity, the RBNZ should lift rates to keep inflation in check.

We expect the RBNZ to follow through with a 25bp increase at next week's meeting, and we have a total of 100bp of hikes pencilled in for 2014.

Main forecasts for New Zealand

	2013	2014	2015	Q313	Q413f	Q114f	Q214f	Q314f	Q414f	Q115f
GDP (y-o-y)	2.8	3.4	2.6	3.5	3.3	3.6	4.0	3.3	2.7	2.7
CPI (y-o-y)	1.1	2.5	2.3	1.4	1.6	2.1	2.5	2.5	2.9	2.5
NZD*	0.83	0.87	0.88	0.83	0.82	0.84	0.85	0.86	0.87	0.88
OCR*	2.50	3.50	4.50	2.50	2.50	2.75	3.25	3.25	3.50	3.75

Source: Statistics New Zealand, RBNZ, HSBC forecasts, *end period

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