Macro
New Zealand Economics

The RBNZ Observer

Another 25bp hike expected next week

- **New Zealand's economy remains on track to post one of the strongest growth rates in the OECD in 2014**
- **With demand continuing to pick up strongly, we expect the RBNZ to raise rates further next week**
- **The recent fall in dairy prices and the high NZD may see the RBNZ hike by less than current market pricing implies over the next year**

New Zealand's boom continues

The RBNZ became the first developed world central bank to hike rates this cycle, in March, raising its cash rate by 25bp to 2.75%. We expect the RBNZ to follow through with a further 25bp rate hike next week, as New Zealand's economy remains on track to post one of the strongest growth rates in the OECD in 2014.

A number of factors are supporting growth. Post-earthquake reconstruction continues to ramp up. Export commodity prices have risen strongly. New Zealand's housing market is also continuing to strengthen, with prices rising further in January and February, after moderating in previous months. With inward migration at 10-year highs, the housing market is likely to strengthen more. Strength in house prices is also supporting household spending, with construction activity rising outside of post-earthquake rebuild-driven construction in Canterbury. Further to this, a combination of rising asset prices and an improving labour market has helped support a rise in consumer spending and confidence.

As a result, business confidence remains close to 20-year highs and business surveys present some upside risk to the RBNZ's growth forecasts. At the same time, domestic cost pressures are continuing to pick up. As a result, the RBNZ is likely to continue to raise interest rates to manage the boom in demand and keep inflation in check.

However, a couple of factors could limit the extent of further rate hikes this year. The first is the recent fall in dairy prices. Dairy prices have fallen 25% since their April 2013 peak – with this fall likely a little quicker than the RBNZ was expecting. In addition, the NZD has continued to strengthen, sitting 2.5% above the RBNZ's expectations so far in Q2. This should help contain cost pressures created by the boom in demand.

Overall, we see a hike of 25bps to 3.00% next week as highly likely. But we expect the cash rate to end this year at 3.50%, compared to the RBNZ's implied projection of 3.75% as a high NZD may do more of the work than the RBNZ is currently assuming.

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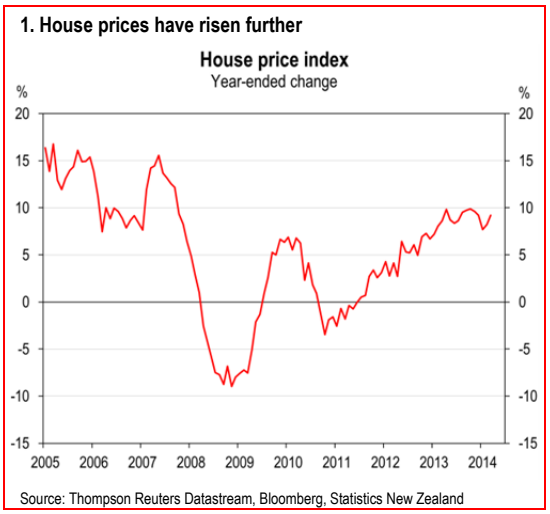
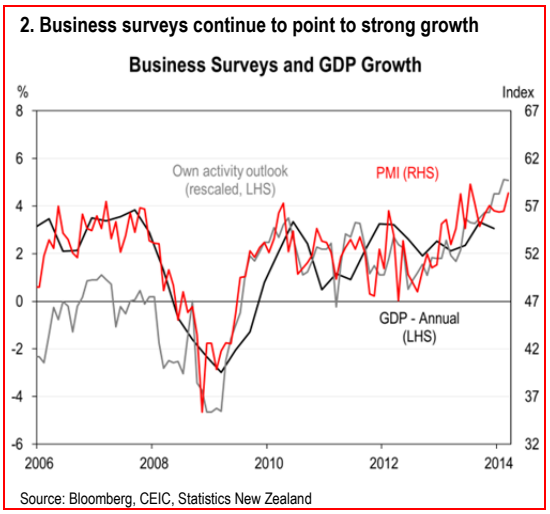




Interest rates likely to continue on gradual path towards normal

New Zealand's economy remains on track to deliver one of the strongest growth rates in the OECD in 2014 – with a number of fundamental factors continuing to provide support. Post-earthquake reconstruction continues to ramp up, a factor that will likely continue to boost activity for a number of years.

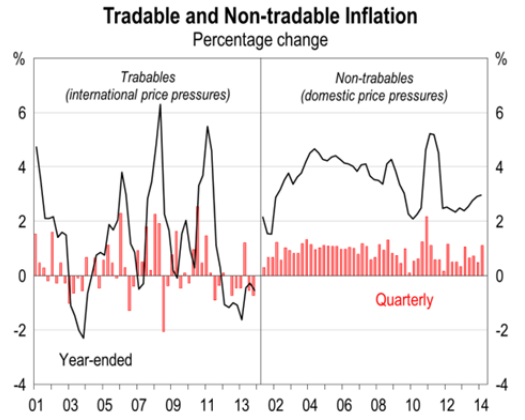
In addition, the housing market in New Zealand remains strong (Chart 1). Higher long-term interest rates, coupled with the implementation of loan-to-value ratio restriction last year saw the market cool over the end of 2013. However, prices are now picking up again, currently rising at an annual pace of +9.2%. With inward migration at the highest level since 2003 and the construction response in the undersupplied Auckland market still subdued, prices are likely to move up further in coming months.

Household spending is also beginning to rise. Construction activity outside of Canterbury is increasing, as high prices encourage new building. At the same time, rising asset prices and an improving labour market have supported a pick-up in consumer spending and consumer confidence continues to track close to seven-year highs, suggesting this strength is likely to continue.

Overall, these factors have seen business confidence remain close to 20-year highs. GDP growth surprised the RBNZ modestly to the upside in Q4 and the recent strength in the business and purchasing manager surveys points to greater momentum in economic activity in the near term than the RBNZ was projecting in its latest set of forecasts in March (Chart 2).

However, CPI inflation was a touch softer in Q1 than the RBNZ had expected, as an elevated exchange rate helped offset the impact of rising domestic cost pressures (Chart 3). Nonetheless, we see the RBNZ's focus as likely to be on the inflation outlook 6-18 months ahead. In this regard, with New Zealand's economy already operating at capacity, the strong pick-up in demand will likely put on-going pressure on domestic costs. This is likely to see CPI inflation continue to increase. As a result, we expect the central bank to continue the gradual process of returning interest rates towards more normal levels to keep medium-term inflation contained.

3. Inflation moderated slightly in Q1…



Source: Statistics New Zealand

4. …although cost pressures are likely to increase from here

Source: RBNZ, Thompson Reuters Datastream

Increasing cost pressures can already be seen in the survey data, with firms' pricing intentions having increased significantly over the past year to a level consistent with inflation in the upper half of the RBNZ's target band (Chart 4). The RBNZ will want to keep these pressures contained and will be watching for evidence that a stronger pricing environment is putting upward pressure on inflation expectations.

Lower dairy price and higher NZD may constrain pace of hikes

Given rising cost pressures and a booming economy, we expect the RBNZ to gradually raise interest rates through 2014 and 2015. However, a number of recent developments could limit the pace of rate hikes from the RBNZ this year.

The first is the recent fall in dairy prices from elevated levels. Dairy prices have fallen 25% from the peaks reached in April last year (Chart 5). Supply in a number of key exporting countries, including New Zealand, has improved in recent months, following weakness seen over the end of 2012 and the beginning of 2013. The RBNZ expected some moderation in export prices, given the improving global supply picture, however, the recent decline is likely stronger than it had initially factored in.

More broadly, dairy prices remain elevated relative to the average of the last decade – and the combination of the recovery in rural output and the strong run-up in prices seen in 2013 still represents a significant boost to rural incomes, a factor likely to support wider investment and spending activity for some time.

Second, the high level of the NZD will likely also present a concern for the RBNZ (Chart 6). The New Zealand dollar TWI is currently around 2.5% above the RBNZ's initial projections for Q2. By itself, this will present a dampening impact on domestic inflation, and we expect the NZD could drift higher from here, helping to contain New Zealand's boom. Overall, we expect a total of 75bp of further rate hikes in 2014, compared to the RBNZ's projections of 100bp of hikes and below current market pricing of 86bp – as a strengthening NZD could do more of the work than the RBNZ is currently assuming.

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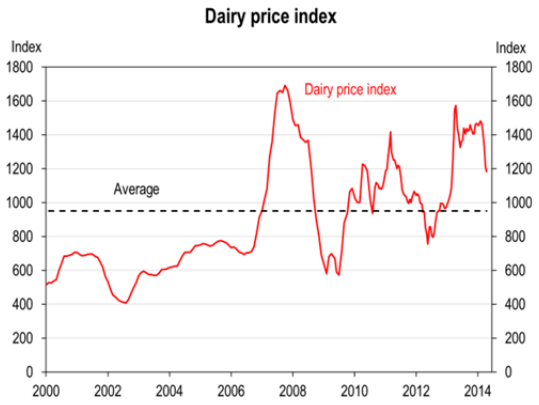
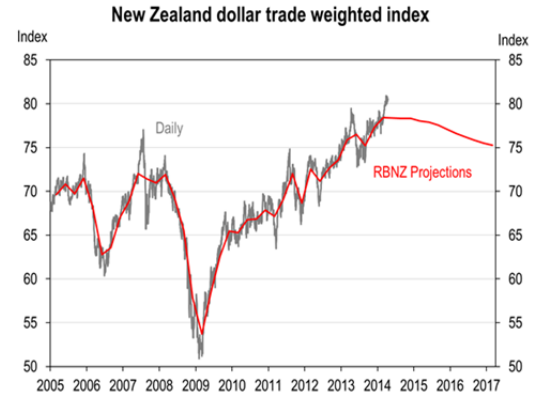
5. Dairy prices have fallen from elevated levels



Source: Global Dairy Trade

6. The NZD is running above the RBNZ's expectations



Source: RBNZ

Bottom line

New Zealand's economy remains on track to post strong growth in 2014, supported by post-earthquake reconstruction, rising asset prices and strengthening household spending.

With demand picking up strongly, we expect the RBNZ to deliver a further 25bp hike next week, raising the cash rate to 3.00%.

We expect the RBNZ to continue to raise interest rates gradually through 2014 and 2015, although the recent fall in dairy prices and the strengthening exchange rate may limit the extent of rate hikes in 2014.

Main forecasts for New Zealand

	2013	2014	2015	Q114e	Q214f	Q314f	Q414f	Q115f	Q215f	Q315f
GDP (y-o-y)	2.7	3.5	3.0	3.5	3.8	3.5	3.3	3.2	3.1	3.0
NZD*	0.83	0.87	0.88	0.85	0.85	0.86	0.87	0.88	0.88	0.88
OCR*	2.50	3.50	4.50	2.75	3.25	3.25	3.50	3.75	4.00	4.25

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

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