

Onwards and upwards

Normalising monetary policy in Australia and NZ

- **The RBA sounds considerably more hawkish than the RBNZ.**
- **Views on global growth and commodity prices can explain much of the difference in tone, but NZ has also had a much deeper recession.**
- **Once tightening starts, the RBNZ has more work to do, with the cash rate further below neutral than in Australia. Our money is on the RBNZ's tone becoming a bit more hawkish over coming months.**

Introduction

Turning points are always blindingly obvious in hindsight, but very difficult to identify in real time. It is also around turning points that views tend to diverge. A clear example of that is the rhetoric currently coming out of the central banks of Australia and New Zealand. Glenn Stevens is singing a relatively chirpy refrain while Alan Bollard favours a requiem.

The Reserve Bank of Australia's (RBA) latest *Statement on Monetary Policy* (7 August) noted that "movement towards a more normal setting of monetary policy could be expected at some point if further signs of a durable recovery emerge". This was a remarkable turnaround from the meeting a month previous, where "members noted that the current inflation outlook afforded scope for some further easing."

Compare this to the Reserve Bank of New Zealand's (RBNZ) 10 September *Monetary Policy Statement (MPS)*: "a patchy recovery is underway... However, the medium-term growth outlook remains weak... We continue to expect to keep the OCR at or below the current level through until the latter part of 2010."

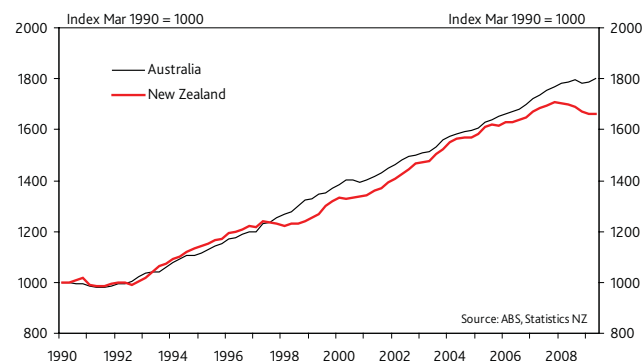
A surge in business and consumer confidence to the highest levels since 2007 was probably the most significant development leading to such a sharp reversal in the RBA's tone. Crucially, business and consumer confidence in New Zealand has now also surged. Will the RBNZ stage an equally dramatic change in tone in their October OCR review? We examine a few economic 'hot topics', comparing the two countries on each.

1) Inflation

Inflation in both Australia and New Zealand is not a near- or medium-term issue for the central banks. Annual CPI inflation is currently in the sweet spot in the two countries (NZ 1.9%, Australia 1.5%). Inflation expectations are creeping back upwards but remain at fairly tame levels, and wage growth in the two countries is falling.

Nonetheless, interest rate settings must be normalised at some point, and the RBA looks likely to start its tightening cycle well in advance of the RBNZ. Figure 1 makes it clear why: Australia saw only one quarter of GDP contraction (-0.7% in December 2008) whereas NZ had five, for a cumulative fall in economic activity of nearly 3%. New Zealand's much deeper recession means there is considerably more slack in the economy to be taken up before growth becomes inflationary. That said, history suggests that NZ's current cash rate is considerably more stimulatory than Australia's – on average it has been 75 basis points higher than in Australia but is currently 50bp below, suggesting that NZ's cash rate is a good 125bp further below neutral.

Figure 1: Real GDP indices



When inflation does turn higher, it may well do so very quickly in both countries. Both central banks will be very aware of the inflation risk as they try to balance the dangers of letting inflation out of the bag versus choking off the economic recovery.

For further information, questions or comments contact Brendan O'Donovan, telephone (04) 470 8250, email bdonovan@westpac.co.nz

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2) Views on the world outlook

The RBA sounds more cheerful when talking about the global economic outlook than does the RBNZ. From the *RBA Statement of Monetary Policy* of 7 August:

“The global economy is stabilising ... Forecasts for world growth are being revised up for the first time in more than a year. The pick-up in economic conditions is most evident in China ... In the advanced economies ... the rate at which output is contracting has slowed noticeably ... Significant headwinds remain ... Reducing public-sector debt to more sustainable levels is likely to weigh on growth in many of the advanced economies for some time. In contrast, prospects for growth in the Asian region, which is becoming increasingly important to Australia, look more positive.”

Contrast this with the RBNZ *MPS* of 10 September:

“[We’ve seen a] recovery in our trading partner economies in the June quarter and these look likely to continue expanding in the short term... The recent improvement in global economic activity could prove short-lived. Much of the improvement seems related to a stabilisation in stock levels ... Over the medium term, we expect fiscal consolidation and balance sheet adjustment in Western economies to weigh on the outlook for global growth”.

Back in the June *MPS*, RBNZ projections were based on far worse global growth than Consensus is now suggesting (*Table 1*), but in September they capitulated and adopted Consensus. Nonetheless, the above statement suggests they remain highly sceptical of the durability of the global recovery, whereas the RBA is focusing on the Asian recovery, a story which they do buy into. Since the *MPS*, Consensus growth forecasts have been revised up further, making the RBNZ’s scepticism, while certainly not unreasonable, a departure from the prevailing view.

Table 1: Consensus Forecasts for NZ trade-weighted world GDP growth

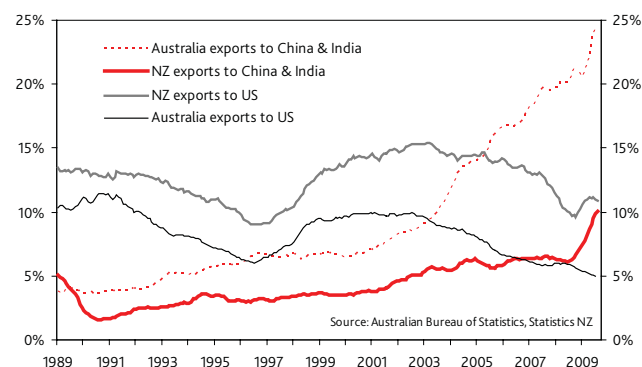
Survey completed 14 September 2009

	RBNZ June MPS Forecast	RBNZ Sep MPS Forecast	Sep Consensus Forecast
2009	-2.6%	-1.8%	-1.5%
2010	1.4%	2.4%	2.8%

Does the data support Australia putting a much higher weight on Asian vs. US growth than the RBNZ does?

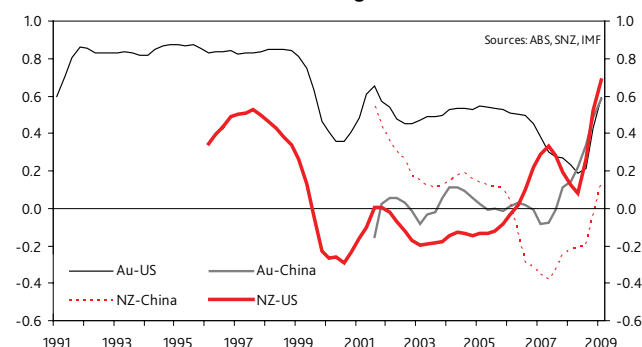
The developing Asia (particularly China) share of exports for Australia and NZ has been rising sharply, but as *Figure 2* shows, China and India take around a quarter of Australia’s exports versus only 10% of New Zealand’s. Exports to the US remain more important to the NZ economy – just – but the recent pick-up in NZ’s exports to China and India certainly suggests that these regions warrant close attention when making economic forecasts for NZ.

Figure 2: Share of annual exports by value



The Australian central bank used to have an economic forecasting model based on what was historically an extremely high and stable correlation between the Australian and US economies. However, in recent years this correlation has broken down (*Figure 3*). The correlation of Australian and Chinese GDP growth is now at least as strong. The story is less clear for NZ – the correlations have not been stable through time. But it seems reasonable to conclude that the correlation with China’s GDP growth is likely to continue to increase as China takes an increasing share of NZ’s exports and has an ever-greater impact on world prices for NZ’s export commodities.

Figure 3: 8-year rolling correlations between annual GDP growth



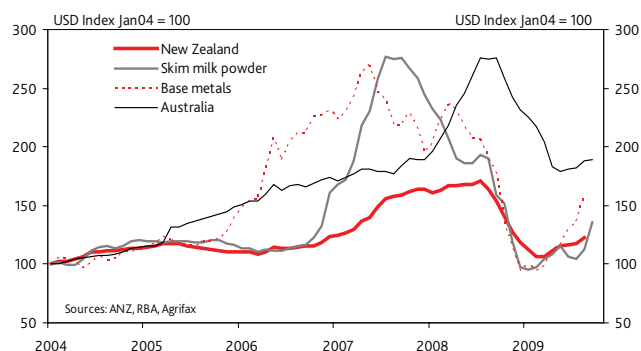
3) Commodity prices

Prices for both NZ’s and Australia’s export commodities fell sharply as the global economic turmoil hit. However, it could have been worse – both NZ and Australia have benefited from the fact that we sell basic materials rather than luxury goods, and demand from China, in particular, has held up. NZ’s agricultural commodity prices have not performed as strongly as Australia’s mineral-dominated index on average (*Figure 4*), but nonetheless it is fair to say that both countries have been pleasantly surprised that commodity prices have not fallen further, and that key prices (e.g. metals, skim milk powder) have already lifted sharply off their lows.

The RBA is relatively bullish: “the terms of trade are expected to record a fall of just over 20 per cent from their 2008 peak. This would nonetheless still leave the terms of trade around 45 per cent above the average level that prevailed between 1980 and

2000". The RBNZ in June lamented that NZ's soft commodities were missing out on the recovery. However, by September, following spectacular increases at two monthly online dairy auctions, they had changed their tune: "we now predict the world prices of New Zealand's exports to rise from their current level over the coming year, before holding up". For the terms of trade this would imply a total fall by end-2010 of 5 percent from the peak, to be 24 per cent above the 1980-2000 average. Thus though the fall is smaller, the peak was lower: the medium-term terms of trade level gain expected by the RBNZ is about half that expected by the RBA.

Figure 4: USD commodity price indexes for NZ and Australia

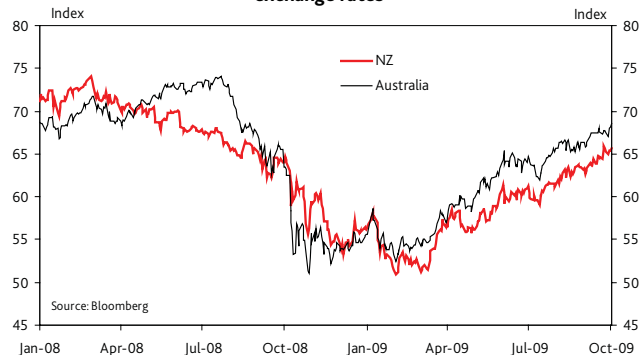


4) Exchange rates

In open economies like NZ and Australia, the exchange rate matters enormously. Both countries saw their exchange rates fall sharply over 2008, but then bounce back quickly as appetite for risk returned and the USD fell out of favour (Figure 5).

The NZ dollar has appreciated by more than the AUD against the USD in recent months. The RBNZ suggested in the September MPS that this is "at odds with relative economic developments", given Australia's commodity price out-performance and more hawkish central bank. However, we argue in a recent Bulletin¹ that this ignores two facts: (1) The outlook for NZ has been revised up by more than that for Australia. The NZ economy doesn't have to actually outperform the Aussies for the NZD to appreciate against the AUD – a changed expectation regarding how far we'll be left behind will do. (2) The cross rate is still below its historical mean.

Figure 5: Australia and New Zealand trade-weighted exchange rates



¹ "No need to get cross", Westpac Bulletin 15 September 2009.

The RBNZ has historically tended to fret more about a high exchange rate than the RBA, even though the two currencies have been through similar cycles. However, in the latest MPS the RBNZ moved away from their implicit threat to cut the cash rate further should the exchange rate not fall.

5) Net migration

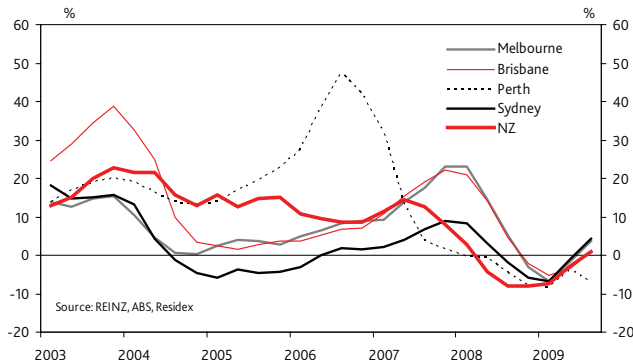
New Zealand is currently undergoing the early stages of what could be a significant surge in net migration. A fall in departures to Australia is the primary driver. Annual net arrivals have lifted from a low of 3,500 last November to 15,600 currently, on their way to a peak of perhaps 25,000, which would almost be on a par with the 1993-96 cyclical peak.

Australia experiences much smaller swings in net migration as a percentage of population.

6) Housing markets

In both Australia and NZ the housing markets are clearly reviving (Figure 6), stimulated by lower interest rates. The Australian market has been further spurred on by a generous first home buyers' allowance, while in NZ a sharp turnaround in net migration is boosting housing demand at a time of very limited growth in the housing supply. House price falls in both NZ and Australia have been quite small compared to both other countries and the size of the run-up in prices over the past 5 years. Although the possibility of a double dip can't be entirely discounted, sentiment has clearly turned positive again. House sales and mortgage finance are growing at a solid pace in both countries. Coming off such stretched levels of affordability, recent developments are causing some consternation amongst financial stability and social commentators in both countries.

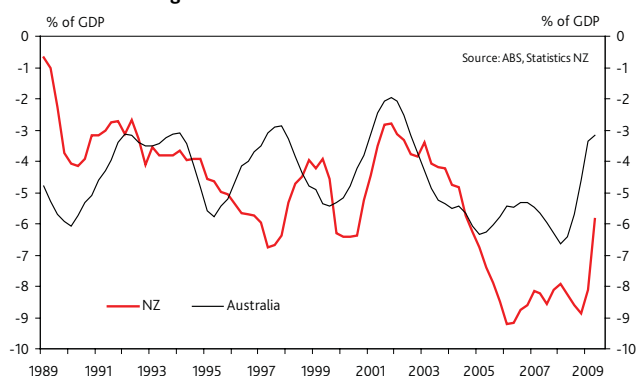
Figure 6: Annual growth in house prices



7) Structural imbalances

Both NZ and Australia have tended in recent years to spend more than we earn, and households are now carrying record-breaking levels of debt. However, NZ's structural imbalances are worse, as shown in the current account deficit. Until a few years ago the NZ and Australian current account deficits moved in similar ranges, but Australia has outperformed in recent years (a minerals boom helped) (Figure 7). NZ's accumulated international debt position is considerably higher: 96.4% of GDP versus Australia's 60.3%.

Figure 7: Annual current account deficit



The RBNZ devoted considerable space in the September *MPS* to the risk that NZ's already marked imbalances could be exacerbated in coming years by a resurgent housing market and falling savings rates. However, they did not discuss what they might do about it – raise rates to cool housing, or cut them to try to lower the NZD and boost exports. Since the *MPS* the current account deficit has improved dramatically from 8.5% to 5.8% of GDP, thanks to revisions and another quarter of data, which must go some way towards alleviating concerns.

Toting it up

In sum, the two economies have many similarities currently, particularly the behaviour of the exchange rate and the housing market. The advantages the Australian economy is currently enjoying relative to NZ are:

- Less extreme structural imbalances (but implications for monetary policy are unclear);
- Stronger commodity prices and terms of trade thanks to a greater exposure to developing Asia.

Despite this, NZ growth is likely to outperform over the coming year for two reasons:

- NZ is coming off a lower base, having had a deeper recession;
- NZ is experiencing a bigger net migration boost.

Are these factors likely to persist?

Structural imbalances: this is clearly worrying Alan Bollard a good deal more than Glenn Stevens – which is quite understandable. However, it is far from clear what the interest rate response should be, if any. It's the old chestnut that the RBNZ cannot control the mix of monetary conditions.

Commodity prices: we see the risks to both the RBA's and RBNZ's forecasts as on the same side, as both depend heavily on the outlook for growth in China. However, NZ's food exports are more exposed to the rising tide of trade protectionism around the world.

NZ catch-up: NZ can afford to have more stimulatory monetary conditions than Australia, given the more substantial slack in the NZ economy. However, it could well be that the slack disappears fairly quickly in an agricultural/dairy bounce-back. That said, we see labour market weakness persisting for some time. It is important that the RBNZ bear in mind that they have a bigger tightening job to do once they get going, with the cash rate starting further below its average or neutral level than in Australia.

Net migration: that Australian employment is expected to outperform NZ's is, on the face of it, a substantial risk to our view that the number of Kiwis heading over the Tasman will remain subdued over the coming year. However, it is important to note that employment in Australia is still expected to keep falling over the next year – meaning an even worse labour market here may provide a strong "push" factor, but jobs will not be plentiful over the ditch either.

On the whole, the NZ and Australian economies will likely perform more similarly over the next year than they have in the year past.

Conclusion: Getting back onto the same page

In the last *MPS* the RBNZ already took large steps closer to the RBA's position: they have adopted *Consensus* forecasts rather than taking their own much more pessimistic view, and they have given up on talking the exchange rate lower. The main unresolved disparity is that the RBA appears less sceptical about the durability of the global recovery, at least in trade-weighted terms. It should become clearer over the next six months, as the inventory cycle peters out, who is right.

Market pricing doesn't necessarily *validate* the views of the central banks but does suggest the differences are being given some credence. Pricing suggests the RBA will tighten first: by the start of December this year versus March 2010 for the RBNZ.

In Australia's case, market pricing of a hike late this year is consistent with the rhetoric coming from the central bank, but NZ market pricing of a hike in March is much more hawkish than the RBNZ, who continue to reiterate that they do not expect to raise rates until the latter part of 2010. We suspect both sides will have to give. The RBNZ's 'promise' is losing credibility fast, but they may well surprise the market by digging in their heels for longer than is currently anticipated.

Brendan O'Donovan, Chief Economist, Ph: (64-4) 470 8250

Sharon Zöllner, Senior Economist, Ph: (64-4) 381 1426