

# AUSTRALIA & NEW ZEALAND WEEKLY

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# Stevens will discourage rate cut hopes

## Australian outlook not all gloom

Speaking to CEDA Tuesday RBA Governor Glenn Stevens is unlikely to be as gloomy about the Australian or global economic outlook as the market is now becoming. It's true that last week's third quarter GDP numbers confirmed the big business investment boom of the last three years is over. It's also true that those same numbers showed that the sharp upswing in residential construction in the second quarter was premature. So too the national accounts showed that the drought has already hit rural output, that productivity plunged 1.6% in the third quarter, and that despite three years of high prices and an investment boom, exports in the quarter were up only 0.7% over the previous quarter. At 2.2% for the year to September and only 0.3% for the quarter, GDP growth was one of the weakest since the long expansion began fifteen years ago\*.

Stevens might also point, however, that there are compelling signs that the broad pattern expected for 2007 is beginning to form. The most important of these signs is that the volume of exports was up 6% over the year to September, the second strongest four quarter outcome since the export volume downturn at the start of this decade. That suggests export volumes will indeed pick up through 2007 as the additional capacity provided by the investment boom becomes available. If export volumes rose 7.5% over the year that alone would contribute one and a half percentage points to output growth. And while housing construction fell in the third quarter, the fall was so small that it was more than equalled by an increase in additions and renovations. Overall, the residential construction sector expanded a little over the quarter. The three year decline in the industry is ending and it will likely be followed by a very moderate upswing through 2007. Household consumption, always the biggest component of demand, increased 0.7% in the September quarter and 2.8% over four quarters – not at all flash, but persistent and quite strong enough for Stevens.

Without too much strain Stevens can find some other more recent signs of life in the Australian economy. Building approvals were sharply down for October, suggesting interest rate increases this year have had an effect. So too the number of new mortgages for owner occupation fell in August and September and the growth of housing lending overall slowed in September and October. But retail trade growth was higher than expected in October, and continued a firming trend apparent over the last fifteen months. Last week's news that the number of jobs increased by 36,100 in November, more than three times our estimate, showed that the decline in October was not the end of a prolonged period of jobs growth. In the year to November the number of

employees has increased by just over a quarter of a million. The unemployment rate remains at its thirty year low of 4.6%. (It's not at all clear why employment is so much stronger than output growth, but the general shortage of labour and the unwillingness of employers to let people go must be part of the story.) The outlook for 2007 continues to depend on a stronger and more persistent increase in export volumes than has yet been apparent, but Stevens is unlikely to leave the market with any sense that the central bank might be contemplating interest rate cuts.

\*The Lowy Institute recently published my *Quiet Boom*, an examination of the causes and consequences of Australia's record economic expansion – now in its sixteenth year. This is a link to the paper:

<http://www.lowyinstitute.org/Publication.asp?pid=506>

# Theory versus practice at the RBNZ

Bollard a reasonable man

If the Reserve Bank of New Zealand believed its own theory it would have increased the cash rate in October. In our innocence we thought it would. It might have tightened with the *Monetary Policy Statement* last week, but as we now more sensibly expected it didn't. We have wised up to the contrast between theory and practice at the RBNZ. In theory it forecasts inflation using an output gap methodology, which effectively means that it targets GDP growth as a proxy for its inflation target. In the *Statement* it has been compelled by the abundant evidence to revise up its projections for output growth through 2007 and into 2008, and as a consequence revise up its inflation forecast. The high likelihood of this twin revision is what lead us to expect a tightening in October. If RBNZ Governor Alan Bollard had quite as much confidence in the RBNZ forecasting procedure as his younger colleagues do, he would certainly have tightened last week. Not so, because Bollard is a reasonable man. It's certainly true that New Zealand output growth is stronger than the Bank expected, as we have been arguing for quite a while. But if headline inflation is about to tumble, as the RBNZ readily acknowledges, and if the most reliable of the core measures slowed in the September quarter, as it did, it is quite hard to rationalise an increase in an already punitive 7.25% cash rate. This is especially so if the New Zealand dollar is trading at high levels, as Bollard concedes in the *Statement*.

While leaving in place the apparatus of the output gap methodology and its scary inflation forecasts, Bollard is feeling his way. We think he will want a bit more evidence that inflation is actually likely to return to 3% in 2008, as his modelers are now telling him. That's why we think the most important number before the January 25 cash rate review will be the January 17 fourth quarter consumer price index, rather than the activity indicators now getting the attention of the market. We take it as a given that New Zealand output growth will remain brisk, even compared to the upwardly revised RBNZ forecasts. What is not so clear is that inflation will necessarily return to or beyond 3% once the oil price fall has worked through. If as we expect Q4 inflation shows a dramatic drop in the headline rate and no acceleration in the core rate, we doubt Bollard will wish to tighten. The next big number will then be the February 5 labour cost index, which precedes the March 8 Monetary Policy Statement. All up we would put the chance of another tightening in 2007 at 40%, but no higher. (We expect to see October retail sales up Thursday up 0.7%, stronger than the average outcome over the last twelve months but weaker than the September increase of 1.2%.)

Instead of a tightening we might see the RBNZ paying more attention to what is actually happening to inflation and to wages, and less to what its output gap models tell it should be happening. Last week's RBNZ *Statement* coincided with the publication of an RBA discussion paper claiming that trimmed mean measures of underlying inflation are both more accurate measures of core inflation than other measures, and also useful predictors of inflation three or four quarters ahead\*. As the authors show, this is not only true of Australia, but of the US and Japan as well. (It would be useful if the RBA published regular updates of its measure of US trimmed mean inflation, but it's afraid of the limelight.) As it notes in its *Statement* the RBNZ has researched core and other inflation measures. Statistics New Zealand has got in well ahead of the Australian Bureau of Statistics and now publishes trimmed mean measures at the same time as it publishes the headline consumer price index. But for all that the RBNZ gives the core measures very little weight. In last week's *Statement* it indicates that the annual trimmed mean measure has increased, without mentioning that the quarterly rate fell in the most recent quarter.

\*Andrea Brischetto and Anthony Richards, *The Performance of Trimmed Mean Measures of Underlying Inflation* RDP 2006-10, available on the RBA website

**John Edwards**

# Weekly Calendar

**Week commencing Monday December 11, 2006**

Country/ Region	Event or Economic Release	Period	HSBC	Market F'casts Cons	Range	Actual Previous
<b>Monday December 11, 2006</b>						
NZ	Terms of Trade Index (3Q)					
JP	Consumer confidence (05:00 GMT)	DI	Nov	48.7	-	48.4
UK	DCLG house prices (09:30 BST)	Year	Oct	8.5%	-	8.0%
UK	Trade in goods and services (09:30 GMT)	Global (GBPbn)	Oct	-6.6	-	-6.6
		Non-EU25 (GBPbn)		-4.3	-	-3.9
<b>Tuesday December 12, 2006</b>						
AU	National Australia Bank's November Business Survey					
AU	RBA Governor Glenn Stevens Speaks					
UK	CPI (09:30 BST)	CPI - year		2.5%	2.6%	2.4%
		RPI - month		0.2%	0.1%	0.1%
		RPI - year		3.8%	3.6%	3.7%
		RPIX		3.1%	3.2%	3.2%
GER	ZEW survey (10:00 GMT)	Expectations	Dec	-26.0	-25.0	-28.5
		Current conditions		50.0	55.0	53.0
UK	CBI industrial trends (11:00 BST)	Volume of output (% net balance)	Dec	-3	-	+5
US	Trade balance (13:30 GMT)	Trade balance (USDbn)	Oct	-64.0	-63.3	-64.3
US	IBD/TIPP economic optimism (15:00 GMT)	Month	Dec	53.0	-	55.7
US	FOMC rate announcement (19:15 GMT)	Fed funds		5.25%	5.25%	5.25%
<b>Wednesday December 13, 2006</b>						
AU	Westpac December Consumer Confidence					
JP	Current account balance (23:50 GMT)	NSA (JPYbn)	Oct	1374.7	1406.6	2024.9
JP	Industrial production (04:30 GMT)	Month	Oct, final	1.6%	-	1.6%
		Year		7.4%	-	7.4%
US	Retail sales (13:30 GMT)	Month	Nov	0.2%	0.1%	-0.4%
		Ex-autos		0.3%	0.3%	-0.4%
US	Business inventories (15:00 GMT)	Month	Oct	0.5%	0.4%	0.4%
<b>Thursday December 14, 2006</b>						
AU	Australia's December Consumer Inflation Expectations					
AU	Dwelling Starts		3Q			
NZ	Retail Sales		Oct			
UK	Retail sales (09:30 GMT)	Month	Nov	0.0%	0.1%	0.9%
		Year		2.9%	3.0%	3.9%
US	Initial jobless claims (13:30 GMT)	Week (000's)	Wk 9 Dec	330	-	324

# Weekly Calendar (continued)

Week commencing Monday December 11, 2006

Country/ Region	Event or Economic Release	Period	HSBC	Market F'casts Cons	Range	Actual Previous
<b>Friday December 15, 2006</b>						
NZ	Manufacturing Activity	3Q				
JP	BoJ Tankan Survey (23:50 GMT)	Q4				
SWE	Riksbank rate announcement (08:30 GMT)	Large Firms Manufacturers	Dec	24	25	- 24
EMU	CPI (10:00 GMT)	Year	Nov	1.8%	-	- 1.8%
EMU	Industrial production (10:00 GMT)	Month	Oct	0.4%	0.4%	- -1.0%
		Year		4.4%	4.4%	- 3.3%
US	CPI (13:30 GMT)	<b>Month</b>	Nov			
		Headline		0.2%	0.2%	- -0.5%
		Core		0.2%	0.2%	- 0.1%
		<b>Year</b>				
		Headline		2.2%	2.2%	- 1.3%
		Core		2.7%	2.7%	- 2.7%
US	Empire manufacturing (13:30 GMT)	Month	Dec	15.0	20.0	- 26.7
US	Treasury international capital flows (14:00 GMT)	Net long-term TIC flows (USDbn)	Oct	70.0	64.9	- 65.1
		Total net TIC flows (USDbn)		60.0	-	- 53.7
US	Industrial production (14:15 GMT)	Industrial production	Nov	0.1%	0.1%	- 0.2%
		Capacity utilisation		82.2%	82.2%	- 82.2%

Source:- Dow Jones, Reuters, Bloomberg

Notes:- p=preliminary, r=revised, n.f.=not forecast, n.s.a.=not seasonally adjusted, ann.=annualised, bn=billion, m=million

# Monthly Economic Calendar

**Week commencing December 18, 2006**

Monday December 18, 06	Tuesday December 19, 06	Wednesday December 20, 06	Thursday December 21, 06	Friday December 22, 06
AU Housing Industry Association November New Home Sales NZ NBNZ Business Confidence (DEC) JN BoJ Monetary Policy Meeting EC Euro-Zone Trade Balance (OCT)	NZ Visitor Arrivals (NOV) UK RICS House Price Balance (NOV) US Current Account Balance (3Q) US NAHB Housing Market Index (DEC) JN BOJ Target Rate (DEC 19) JN BoJ Monthly Report	NZ Current Account Balance (3Q) UK Bank of England Minutes UK CML, BBA & BSA Mortgage Lending Figures UK CBI December Distributive Trades Survey US Producer Price Index (NOV) US Housing Starts (NOV) US Building Permits (NOV) US MBA Mortgage Applications (DEC 16)	NZ Westpac NZ Consumer Confidence (4Q) NZ Gross Domestic Product (3Q) UK GDP (3Q F) UK Current Account (3Q) JN Merchnds Trade Balance Total (NOV)	US GDP Price Index (3Q F) US Personal Consumption (3Q F) US GDP Annualized (3Q F) US Core PCE (3Q F) US Initial Jobless Claims (DEC 17) US Philadelphia Fed. (DEC) JN BoJ Monetary Policy Meeting Minutes for October 31 EC ECB Euro-Zone Current Account (OCT)
Monday December 25, 06	Tuesday December 26, 06	Wednesday December 27, 06	Thursday December 28, 06	Friday December 29, 06
JN BSI Large Manufacturing (4Q)	JN Overall Hhold Spending (NOV) JN Natl SA CPI (NOV)	US Richmond Fed Manufact. Index (DEC) US S&P/CaseShiller Home Price (OCT) US ABC Consumer Confidence (DEC 26) US MBA Mortgage Applications (DEC 23) JN Vehicle Production (NOV) JN Housing Starts (NOV) JN Construction Orders (NOV)	US New Home Sales (NOV) JN Industrial Production (NOV P)	AU Private Sector Credit (NOV) UK BBA releases November UK Mortgage Lending Figures UK GfK Consumer Confidence Survey (DEC) US Initial Jobless Claims (DEC 24) US Continuing Claims (DEC 17) US Consumer Confidence (DEC) US Chicago Purchasing Manager (DEC) US Existing Home Sales (NOV)
Monday January 01, 07	Tuesday January 02, 07	Wednesday January 03, 07	Thursday January 04, 07	Friday January 05, 07
		US ISM Manufacturing (DEC) US Minutes of Dec. 12 FOMC Meeting US MBA Mortgage Applications (DEC 30)	NZ Trade Balance (NOV) UK HBOS House Price 3Mths/Year (DEC) UK Mortgage Approvals (NOV) UK GfK Consumer Confidence Survey (DEC)	US Initial Jobless Claims (DEC 31) US Pending Home Sales (NOV) US Factory Orders (NOV) US ISM Non-Manufacturing (DEC)
Monday January 08, 07	Tuesday January 09, 07	Wednesday January 10, 07	Thursday January 11, 07	Friday January 12, 07
AU AiG Perf of Construction Index (DEC) AU Building Approvals (NOV) AU ANZ Job Advertisements (DEC) AU Building Approvals (NOV)	AU Retail Sales (NOV) AU NAB Business Survey (DEC) AU Westpac Consumer Confidence (JAN) UK BRC December Retail Sales Monitor	AU Job vacancies (NOV) AU Trade Balance (NOV) AU Exports (NOV) AU Imports (NOV) UK Bank of England's Monetary Policy Committee Meets	AU Employment Change (DEC) NZ ANZ-Business NZ PMI (DEC) UK BOE Announces Rates (JAN 12) US Trade Balance (NOV) EC ECB Announces Interest Rates (JAN)	AU Consumer Inflation Expectation (JAN) NZ Building Permits MoM (NOV) US Advance Retail Sales (DEC) US Business Inventories (NOV)

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