

AUSTRALIA & NEW ZEALAND WEEKLY

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Australia versus New Zealand

Similar circumstances, different outlook

Australia and New Zealand have much in common, but their central banks often diverge. Today's differences are particularly illuminating, for their economies and for the politics of monetary policy making. They also suggest that despite the overwhelming market expectation to the contrary, there is no case at all for tightening in New Zealand.

The numbers show that output growth, domestic demand and consumer price inflation have slowed more rapidly in New Zealand than Australia. In the year to the third quarter of 2006, the latest data available, Australian GDP increased 2.2% and New Zealand GDP 1.3% - both were well below trend, but New Zealand was markedly slower than Australia. Over the four quarters gross national expenditure increased 2.6% in Australia but fell 2.6% in New Zealand. In the year to November retail sales rose 6.7% in Australia, but only 4% in New Zealand. Over the same period the number of residential building permits fell by 0.5% in Australia, and also by 0.5% in New Zealand. At around 15% through to the end of 2006 credit growth in both countries was about the same. Australian export volumes have been slow, but export values are increasing faster in Australia than New Zealand. Headline inflation in both economies was 4% in the year to June but has since fallen. In New Zealand it has fallen more sharply, to 2.7% in the year to December compared to 3.3% in Australia over the same period. In both economies headline consumer prices fell in the fourth quarter. In both economies the trimmed mean measure of inflation has also fallen since June- and again somewhat faster in New Zealand than Australia. In Australia the annualised trimmed mean result for the December quarter was 2%, in New Zealand 1.6%. The only respect at all in which New Zealand is livelier than Australia is in house prices. In New Zealand house price growth has slowed but it is said to be still around 10%. In Australia house prices were flat from 2003 and have only recently started to pick up.

On these numbers neither central bank should be planning an increase in the cash rate, but it should be a substantially bigger risk in Australia than New Zealand. In fact the contrary is the case. Australia is very unlikely to increase the cash rate at the board meeting on Tuesday next week, or in our view anytime this year. Last week, however, RBNZ Governor Alan Bollard indicated that "in the absence of clear indications of a moderation in housing and domestic demand, it is likely that further policy tightening will be required". He committed himself to reassess the outlook in the March 8 Monetary Policy Statement. The market immediately moved to

price in a rate increase, an expectation rationalised by a literal interpretation of Dr Bollard's statement.

Both central banks are committed to a headline inflation target or around 2.5% within a one to three year time frame. (New Zealand's target mid point is actually 2%, but the RBNZ has indicated that 2.5% is fine). The radical difference between Australia and New Zealand is not in economic circumstances but in policy interpretation and forecasting procedure.

The Reserve Bank of Australia believes that the trimmed mean of contemporary consumer price inflation is a reasonably reliable guide to future headline inflation. It thinks that a forecast of output growth compared to capacity eighteen months hence is not a reliable guide to headline inflation eighteen months hence. This is because the growth forecast is uncertain, the estimate of capacity or potential growth is uncertain, and the estimate of the relationship between output growth, employment and inflation is uncertain. In the RBA practice, it is better to feel one's way in monetary policy with small changes in the cash rate based on new information. The RBA is of course sensitive to views about the relationship between capacity, sustainable growth and inflation, particularly in the medium to long term. In recent times, however, the RBA has often made its big monetary policy decisions in the aftermath of a CPI release. In the past few months it has drawn attention to the usefulness of trimmed mean measures in forecasting inflation. The market now reads changes in the trimmed means as guides to RBA moves.

By contrast, the RBNZ is still officially committed to an output gap methodology which forecasts future inflation from a forecast of future output growth, compared to forecast potential growth. It is noteworthy that while Statistics New Zealand publishes trimmed mean measures of inflation, the RBNZ does not use them. In his statement last week, for example, Dr Bollard did not refer to the persistent moderation in core inflation evident in the movement of the trimmed mean. He tied himself to the March 8 MPS, although he will have no significant new inflation data by that date. Yet it is certain that if the trimmed mean is moderating from quarter to quarter, either the RBNZ output gap model is wrong or the trimmed mean is an unreliable guide to medium term inflation. The calibration of the output gap model may be wrong, or the whole methodology may now be unreliable, because if the traditional RBNZ model is right core inflation should now be picking up rather than falling. This is probably why the number is ignored. There are real issues here on which the jobs and prosperity of New Zealander's depend, and which the RBNZ has not publicly addressed.

No doubt Dr Bollard and the RBNZ will sooner or later address them. In the meantime we are going out on a limb in predicting that the RBNZ will not increase the cash rate on March 8. Dr Bollard has now had three successive opportunities to tighten, each of which he has refused. We will change our view if the data proves exceptionally strong but we think there has been enough weakness in the contemporary indicators for retail trade, building consents, exports, and imports to rationalise a view that domestic demand is indeed moderating. We expect that moderation to remain apparent over the next six weeks, and provide sufficient cover for Dr Bollard to once again (and rightly) refuse another increase in New Zealand's already sky high cash rate.

John Edwards

Weekly Calendar

Week commencing Monday January 29, 2006

Country/ Region	Event or Economic Release		Period	HSBC	Market F'casts Cons	Range	Actual Previous
Monday January 29, 2006							
AU	NAB Business conditions		Q4	-	-	-	12.4
Tuesday January 30, 2006							
NZ	Building consents		Dec	-	-	-	-12%
JP	Industrial production (23:50 GMT)	Month	Dec, prelim	0.4%	0.5%	-	0.8%
		Year		4.1%	4.4%	-	4.9%
US	Consumer confidence (15:00 GMT)	Month	Jan	110.0	109.3	-	109.0
Wednesday January 31, 2006							
AU	Private credit			1.1%	1.0%	-	1.1%
NZ	Trade balance	(NZDm)	Dec	-	-	-	-785
UK	Gfk consumer confidence (10:30 GMT)	Balance	Jan	-9	-9	-	-8
US	GDP (13:30 GMT)	Quarter	Q4, 1 st est	3.0%	3.0%	-	2.0%
		Price deflator		1.6%	1.6%	-	1.9%
US	Employment cost index (13:30 GMT)	ECI	Q4	1.0%	1.0%	-	1.0%
		Wages & Salaries		1.0%	-	-	0.9%
		Benefit costs		1.0%	-	-	1.1%
US	Chicago PMI (15:00 GMT)	Month	Jan	54.0	52.0	-	51.6
US	FOMC rate announcement (19:15 GMT)	Fed Funds	Jan	5.25%	5.25%	-	5.25%
Thursday February 01, 2006							
EMU	PMI manufacturing (09:00 GMT)	Index	Jan	56.2	56.7	-	56.5
UK	PMI manufacturing (09:30 GMT)	Index	Jan	51.0	51.8	-	51.9
US	Personal income & spending (13:30 GMT)	Personal income	Dec	0.5%	0.5%	-	0.3%
		Personal spending		0.6%	0.6%	-	0.5%
		Core PCE Deflator					
		Month	Dec	0.2%	0.2%	-	0.0%
		Year		2.2%	2.2%	-	2.2%
US	Jobless claims (13:30 GMT)	Week (000s)	Wk 27 Jan	320	-	-	325
US	ISM manufacturing (15:00 GMT)	Month	Jan	53.0	51.0	-	51.4
		Prices paid		49.0	47.0	-	47.5
US	Pending home sales (15:00 GMT)	Month	Dec	0.5%	0.7%	-	-0.5%
Friday February 02, 2006							
AU	December trade balance	(AUD '000s)		-700	-1000	-	-843
US	Non-farm payrolls (13:30 GMT)	Non-farm payrolls (000s)	Jan	160	145	-	167
		Unemployment rate		4.5%	4.5%	-	4.5%
US	University of Michigan confidence (15:00 GMT)	Month	Jan, final	98.0	97.5	-	98.0
US	Factory orders (15:00 GMT)	Month	Dec	3.0%	1.0%	-	0.9%

Weekly Calendar (continued)

Week commencing Monday January 29, 2006

Country/ Region	Event or Economic Release	Period	HSBC	Market F'casts Cons	Range	Actual Previous
During the Week						
UK	HBOS house prices	Month	Jan	0.0%	-	-1.0%
		3m-Year		9.3%	-	9.9%

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

Our monthly calendar will return next week.

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