Week Commencing February 18, 2008

HSBC

AUSTRALIA & NEW ZEALAND WEEKLY

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Glenn Stevens' revolution

The changing style of the RBA

Since becoming RBA Governor 17 months ago Glenn Stevens has quite dramatically changed the style of the central bank. It now publishes a resume of board discussions. It now announces interest rate changes on the day of decision. Whether or not it changes rates, it is now committed to issuing a statement after each board meeting explaining its thinking. Stevens has insisted so forcibly on the independence of the Bank that he raised interest rates in the course of November's election campaign, dealing the final and mortal blow to the prime ministerial ambitions of the Treasurer who signed the first formal agreement on the Bank's independence to pursue its inflation target. Had he stayed on Stevens' predecessor Ian Macfarlane may have made these changes – he certainly initiated a great many necessary prior steps towards openness and independence – but the unquestionable effect has been to consolidate Steven's leadership. In last week's *Statement on Monetary Policy* another change became apparent, and one quite as important as those preceding it.

When Stevens took over these statements had already advanced in clarity and explicitness to the point where they included both a GDP growth forecast for the year ahead and an inflation forecast. The growth forecast was typically quite close to Treasury's, though over time the inflation estimate had become the Bank's own. The November 2006 *Statement*, the first produced after Stevens took up the job in September, kept the previous pattern. The February *Statement*, however, included a table giving explicit inflation forecasts over the following year and half, though the GDP growth discussion remained meagre. This pattern then continued through to last week's *Statement*, which for the first time included explicit GDP forecasts by quarter, now for more than two years ahead.

There is a double significance in this development. The first is that it marks a final break with the previous practice of minimising public disagreements with Treasury over GDP forecasts. The RBA will now be publishing GDP forecasts every three months. Treasury's practice is to publish growth forecasts with the Budget and the mid year review, and rarely otherwise. Because of its greater frequency of revision the RBA's forecasts will likely take over from Treasury's as the benchmark of the official view, as the inflation forecasts already have. The last remnant of central bank deference to Treasury has been removed. For any Australian government this is something to keep in mind. Its views of the evolution of the Australian economy over the next few years, views which then underpin revenue and spending forecasts, could well be contradicted by the central bank.

The second implication of these forecasts is more important. It suggests that in making its decisions the RBA will henceforward place less emphasis on contemporary inflation numbers and more on forecasts of future inflation based on forecasts of GDP growth. The RBA has moved a little closer to the explicit model of the Reserve Bank of New Zealand, in which the most important determinant of future inflation is the expected future relationship of output and demand to economic capacity. This is the "output gap" approach, which the RBA has in the past been reluctant to acknowledge. It has always, however, taken this relationship into account. Typically it is more salient when the economy is, as now, operating close to the limits of capacity.

The change of emphasis was heralded by Assistant Governor and head of economics Malcolm Edey's speech in March last year, which mentioned that underlying inflation pressures persisted and in particular instanced GDP growth. By November last year the Bank was warning that lower inflation would require a slowdown in domestic demand. Last week it moved on from requiring a domestic demand slowdown to requiring a GDP growth slowdown. The RBA is releasing itself from the expectation (which it had created) that monetary policy moves would be made in response to contemporary inflation numbers. Last week the significance of the change became startlingly apparent in what seem to us to be ambitiously low GDP forecasts for the year ahead. Non farm GDP growth was 4.5% for the year to September, and it would be surprising if it was much less than 4% for the year to December. Yet the RBA expects it to have slowed to 2.75% for the year to June, and remain at this rate for the following twelve months. This is nearly one percentage point less than the average of the expansion since 1991. Interestingly the forecast is based on the assumption that the cash rate remains at 7%.

In the *Statement* the RBA says that mining exports will pick up, that tax cuts and full employment will support household consumption, and that there will be a small upswing in housing construction. It says that business investment growth will fade, but remain at a high level. It also expects a quite sharp increase in rural output. That of course will not directly show up in the non farm measure, but the rise in rural incomes will have an impact right across the economy. It is not at all clear how we get down to 2.75% non farm GDP, particularly if (as assumed) the cash rate remains at 7%. But since the Bank now says directly that output growth must slow in order to get inflation down, it is presumably suggesting that a fall in non farm growth to 2.75% is required even to sustain its parallel forecasts that underlying inflation will be held to 3.5% by the end of this year, and fall marginally to 3.25% by the middle of next year. The RBA mentions tighter credit and slowing growth in the US, Europe and Japan as reasons to expect output growth to slow. It also mentions, however, that the developing economies will continue to do well and they take an increasing share of Australian exports. So far there is no evidence of slowing business credit growth in Australia, a point the RBA itself makes quite strongly. One is left with the only possible conclusion, which is that the cash rate will be increased sufficiently to bring about the slowdown forecast by the Bank – notwithstanding the explicit statement that the slowdown is achieved with no increase in that rate. We expect two more 25bp increases, on in March and one in May, to take the cash rate to 7.5%. It is not at all impossible the RBA will need to do more.

The RBA's militancy on inflation was underlined last week, but it's not of course new. Macfarlane focused on it, and Stevens declared in his first major speech as Governor in early October 2006 that inflation was on rise and would have to be brought under control. The following month the Bank began to publicise its new inflation measures, the trimmed and weighted means, which generally pointed to higher outcomes than the old way of excluding "volatile items" to arrive at a core measure. (In annual terms the trimmed mean has always been higher than the earlier core measure, except for one quarter in which they were the same). Until now, however, there was no change in monetary policy tactics, which had for a while settled on the practice of increasing the cash rate in response to and after an increase in the quarterly inflation rate.

In effect the RBA is now targeting GDP growth as a proxy for inflation, a change of emphasis not surprising given the difficulties it ran into last year. Edey's mid March speech last year clearly suggested the Bank was concerned about underlying inflation, and concerned about it because GDP growth was strong and unemployment quite low. But having created in previous years an association between inflation announcements and policy changes the RBA found itself boxed in between a 0.1% fall in the December quarter 2006 CPI announced in January 2007, and a 0.1% increase in the first quarter 2007 CPI announced in late April. It then waited for the second quarter CPI announced late July. It recorded an increase of 1.2%, giving the RBA the rationale it then needed to tighten in August. Having tightened, however, it then waited for the third quarter CPI issued in October to tighten again at the following meeting, and repeated the pattern with the February tightening after the announcement of the fourth quarter CPI increase in January this year. The RBA is evidently conscious of the long gap in the first half of last year, which it implies in last week's *Statement* was due to the "unexpectedly low" inflation outcomes reported over that period. We ourselves agreed and disagreed at different times with the decisions of the RBA last year, but it seems to us quite unfair and even ridiculous to suggest the RBA made gross errors of judgement. It made sensible decisions based on what it knew.

For the market this new approach by the RBA means that growth numbers like employment or retail sales or of course GDP have become as important as the quarterly price numbers. Changes in interest rates are now less likely to follow quarterly CPI's, which is why the market is looking at another tightening next month and perhaps another in early April, though the next CPI is not out until late April. Numbers bearing directly on inflation are of course still important, and one of the most significant of these is Wednesday's labour price index for the December quarter. We expect an increase of 1%, leaving the annual rate at 4%. We don't expect it, but there's no doubt a rate much higher than 1% will trigger a deafening alarm.

New Zealand's welcome slowdown

Housing, retail sales fade

It's been a while coming but last week's numbers confirmed that the New Zealand housing market is continuing to slow, while also showing that household consumption growth is moderating. The Real Estate Institute of New Zealand data for January recorded that compared to the previous month house prices fell in January, as they had in December. The cumulative decline is less than 2% from the November high, but it has been achieved quickly. The annual rate of increase continues to slow. The time to sale lengthened dramatically and the number of transactions fell in January, the usual house market manifestations as a long upswing fades. The number of permits sought for new housing construction has been falling in trend terms since mid year, another sign that the housing boom is over for New Zealanders. The Reserve Bank of New Zealand has we think put if anything a little too much emphasis on the housing market in rationalising its policy moves. It will be well pleased with the REINZ numbers. So too last week's numbers for retail sales, which increased only 0.1% in December and were revised down for November. Over the whole quarter retail sales volumes increased only 0.3%.

Australia's central bank will be watching these outcomes with envy. The New Zealand retail sales volume increase of 0.3% compares with a 1.6% increase in Australia for the same period, which followed a 2% increase in the third quarter. While New Zealand house prices have started to come down, Australian house prices have begun to accelerate. Inflation in the two economies is strikingly similar. Most of the time the New Zealand trimmed mean inflation measure is very close to Australia's. If the growth trajectories remain so different, however, this pattern may be break up towards the end of this year. Meanwhile the contrast in household consumption growth and the housing markets in Australia and New Zealand underline just how much work the RBA has yet to do to bring down forecast inflation. New Zealand's next rate move will probably be down (though not until 2009). The RBA may not need to get to the RBNZ cash rate of 8.25%, but it will be a lot closer to it before the work is done.

John Edwards

Weekly Calendar

Week commencing Monday February 18, 2008

Country /Region	Event or Economic Release			Period	HSBC	Mkt F'casts Cons	Actual Previous
Monday February 18, 2008							
NZ	New Zealand's January Performance of Services Index						
US	Public holiday, President's Day						
Tuesday February 19, 2008							
AU	Assistant RBA Governor Edey to Address CEDA (09:30)						
AU	RBA issues minutes of February board meeting (11:30)						
AU	Preliminary BoP Imports (11.30)		Month	Jan			-0.3%
US	NAHB housing market index (18:00 GMT)		Month	Feb	20	19	19
JP	Bank of Japan minutes (23:50 GMT)			Jan			
Wednesday February 20, 2008							
AU	Westpac Leading Index (10:30)		Month	Dec			1.0%
AU	DEWR Skilled Vacancies (11:00)		Month	Feb			1.1%
AU	Wage Cost Index (11:30)		Quarter	Q4	1.0%	1.1%	1.0%
			Year		4.0%	4.2%	4.2%
UK	Bank of England minutes (09:30 GMT)			Feb			
US	CPI (13:30 GMT)	***Headline***	Month	Jan	0.27%	0.3%	0.3%
			Year		4.2%	4.1%	4.1%
		Core	Month		0.27%	0.2%	0.2%
			Year		2.4%	2.4%	2.4%
US	Housing starts (13:30 GMT)		Housing starts	Jan	1020	1002	1006
			Building permits		1040	1040	1068
US	FOMC minutes (19:00 GMT)			Jan			
Thursday February 21, 2008							
AU	New Motor Vehicle Sales (11:30)		Month	Jan			1.1%
			Year				11.6%
AU	RBA Foreign Exchange Transaction (11:30)		AUDm	Jan			546
AU	Average weekly wages (14:30)		Quarter	Nov			1.0%
			Year				4.9%
NZ	Credit card spending (13:00)		Year	Jan			7.6%
US	Initial jobless claims (13:30 GMT)		Initial claims (16/02)	Wk 16 Feb	350	-	348
			Continuing claims (09/02)		2790	-	2761
US	Philadelphia Fed (15:00 GMT)		Month	Feb	-4.0	-10.0	-20.9
Friday February 22, 2008							
EMU	PMI surveys (09:00 GMT)	***Index***	Manufacturing	Feb, flash	52.3	52.3	52.8
			Services		51.2	50.2	50.6

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 Monday February 25, 2008

Mon – February 25, 08	Tue – February 26, 08	Wed – February 27, 08	Thu – February 28, 08	Fri – February 29, 08
		NZ Building Permits (JAN) AU Construction Work Done (4Q)	AU Private Capital Expenditure (4Q) NZ NBNZ Business Confidence (FEB)	NZ Trade Balance (JAN) AU Private Sector Credit (JAN)
Mon – March 03, 08	**Tue – March 04, 08**	**Wed – March 05, 08**	**Thu – March 06, 08**	**Fri – March 07, 08**
AU TD Securities Inflation (FEB) AU TD Securities Inflation (FEB) AU Company Operating Profit (4Q) AU Inventories (4Q) AU RBA Commodity Index SDR (FEB)	AU Retail Sales (JAN) AU Current Account Balance (4Q) AU RBA Cash Target (MAR)	AU Gross Domestic Product (4Q)	NZ Reserve Bank of New Zealand Reviews Official Interest Rate AU Trade Balance (JAN) AU Building Approvals (JAN) AU Exports (JAN) AU Building Approvals (JAN) AU Exports (JAN)	AU Foreign Reserves (FEB) 7-13 MARCH NZ REINZ House Sales (FEB)
Mon – March 10, 08	**Tue – March 11, 08**	**Wed – March 12, 08**	**Thu – March 13, 08**	**Fri – March 14, 08**
AU HIA New Home Sales (JAN) AU ANZ Job Advertisements (FEB)	NZ Terms of Trade Index (4Q) AU Home Loans (JAN) AU Investment Lending (JAN)	NZ Food Prices (FEB) AU Westpac Consumer Confidence (MAR)	NZ Retail Sales (JAN) NZ Retail Sales Ex-Auto (JAN) NZ Business NZ PMI (FEB) AU Consumer Inflation Expectation (MAR) AU Employment Change (FEB) AU Unemployment Rate (FEB) AU Participation Rate (FEB)	NZ Manufacturing Activity (4Q) NZ Non Resident Bond Holdings (FEB)
Mon – March 17, 08	**Tue – March 18, 08**	**Wed – March 19, 08**	**Thu – March 20, 08**	**Fri – March 21, 08**
NZ New Zealand's February Performance of Services Index		AU Westpac Leading Index (JAN) AU DEWR Skilled Vacancies (MAR) AU Dwelling Starts (4Q) AU Preliminary BoP Imports (FEB) NZ Credit Card Spending (FEB)	NZ Visitor Arrivals (FEB) AU New Motor Vehicle Sales (FEB) AU New Motor Vehicle Sales (FEB)	

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