Harbour Navigator

A tale of two central banks

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Yesterday's interest rate decision and statement from the US Federal Reserve (US Fed) highlighted a stark difference in approach with the Reserve Bank of New Zealand (RBNZ). While the RBNZ is projecting to keep rates at record lows until 2019, the US Fed are continuing to signal the steady removal of stimulus through 2017, 2018 and 2019. We are sceptical of both extremes, picking that the two central banks will meet somewhere in the middle with cautious hiking paths.

As expected the US Fed lifted the Fed Funds target range by 25 basis points from 1% to 1.25%. What was less expected by the market was the fact that the US Fed have retained their 'dot plot' projections of one more hike in 2017, 3 hikes in 2018, and another 3 hikes in 2019. Furthermore, for the first time, the US Fed have released a plan of how they expect to start reducing their balance sheet later this year. Once implemented, this will leave reserve balances at a "level appreciably below that seen in recent years"[1]. This amounts to a withdrawal of liquidity from the financial system.

In continuing the theme of stimulus removal, the US Fed is looking through a recent string of softer US economic data releases. In particular, for 3 consecutive months, US Consumer Price Index (CPI) inflation has come in lower than market expectations, raising the question of whether the US Fed would pause and reconsider the plan it set out earlier in the year. However, at the moment the US Fed is placing more weight on the strength of the US labour market, where the unemployment rate has fallen from a peak at 10% down to 4.3%. With the US Fed judging that there is little spare capacity left in the economy, their assessment appears to be that waiting too long to remove accommodation would be unwise.

Meanwhile, in New Zealand, the RBNZ has taken the opposite approach. In last month's Monetary Policy Statement, the RBNZ looked through a string of firmer NZ inflation indicators, including stronger than expected NZ CPI inflation in Q4 2016 and Q1 2017, rising inflation expectation surveys, and market measures of inflation expectations lifting. By sticking to their projections that rates will remain at record lows until 2019, the RBNZ has come to the opposite judgement. That is, that tightening too early could undermine growth and forestall the anticipated gradual increase in inflation. Bruised by the experience of tightening in 2014 (and reversing that move in 2015 and 2016), the RBNZ appears to have a high threshold to meet before signalling a new tightening cycle.

As the global economy continues its post-GFC reflation, in our view it is unlikely that the US and NZ economies will evolve as far out-of-sync as the US Fed and RBNZ projections imply. The market itself is almost ruling out the US Fed's plan, with a view that the reflation trade is over. In our opinion, the answer is likely to be somewhere in between – with the RBNZ coming around to the idea of rate hikes, and the US Fed delivering a more modest removal of stimulus than outlined.

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[1] US Fed Chair Janet Yellen, Press Conference June 14 2017

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