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Is New Zealand economy heating up?

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Effective March 13, Reserve Bank of New Zealand (RBNZ) switched its monetary policy stance, from easy money to tight money.

The official cash rate (OCR) is now 2.75 percent, rising from 2.50 percent.

The OCR is the benchmark interest rate for the economy: a kind of "lighthouse signal". It reflects the money market tightness or otherwise, which is influenced by RBNZ's open market operations. Known as the interbank lending rate, it is the rate at which commercial banks borrow overnight from each other for meeting temporary liquidity shortages.

The previous rate, 2.50 percent since March 2011 prevailed unchanged over thirty six months. As the circumstances then were recessionary, RBNZ's monetary policy stance was expansionary. Now, it is reversed with the rise in OCR.

As the interbank lending rate rose, banks raise interest rates on all categories of loans. Borrowers with mortgages and other loans have to pay higher interest payments.

When interest rates increase, spending will be less on goods and services. Depositors would begin to earn a higher rate of interest on their deposits. Savers will have thus greater incentives to save.

Less spending and greater saving would lead to fall in aggregate demand. There will be less pressure on prices to rise.

The economy would cool off.

The RBNZ Governor made it clear: "It is necessary to raise interest rates toward a level at which they are no longer adding to demand".

NZ first to raise the rate

By raising OCR, NZ became the first developed country to quit expansionary money policy mode, adopted since the global economic downturn. In July 2008, it reduced the OCR from 8.25 percent to 8 percent. As conditions persisted, RBNZ reduced over time to the lowest at 2.50 percent in March 2011.

The rise to 2.75 percent comes after 3 years.

The RBNZ Governor has hinted further increases in OCR. It might well be 5 percent in 2017.

Advanced economies are yet to recover from the global recession of 2008. Their growth rates are poor and job increases are painfully slow. The US monetary stimulus is still continuing, although at a lower rate. On Wednesday, the US central bank chair announced its decision to reduce its monthly addition to money supply by scaling back bond purchases by US$ 10 billion. This would bring down the monthly bond-buying to US$55billion from US $85billion last year. Once the monetary stimulus halts, interest rate would rise, perhaps in early 2015.

As of now, the US benchmark rate is a close zero percent. The corresponding rates in percent today are: UK: O.5; Euro zone: 0.25; Japan: zero; Australia: 2.50.

Fiji's policy rate is 0.5 percent.

Why the Kiwi's tightening mode?

In 2013, NZ's economy grew by 2.7 percent. In the fourth quarter of 2013, its output grew by 0.9 percent, outpacing the US (0.6 percent), the UK (0.7 percent) and Australia (0.8 percent).

That also marked NZ's 12th consecutive quarter of growth, a stunning record!

The Paris-based Organization for Economic Cooperation and Development predicts that NZ will grow in 2014 by 3.3 percent, USA by 2.9 percent, Australia by 2.6 percent; and Euro zone by 1 percent.

As Australia has slowed down with its subsiding mineral boom, NZ economy has taken off, thanks to the extended period of low interest rates and continued strong growth in the construction sector. The growth is facilitated by a steep rise in dairy exports to China. Further, surge in net immigration, especially from China, has boosted the Kiwi housing demand.

Weak import price inflation and the high Kiwi dollar have held down inflation so far.

As spare capacity is now shrinking, inflationary pressures are building up in the non-tradables sector. Although there has been some moderation in the housing market because of restrictions on high loan-to-value ratio mortgage lending, RBNZ says interest rate increase is needed.

That is the reason for raising the OCR.

Implications for Fiji

Inflationary conditions in NZ are due to its soaring dairy prices, the rebuilding expenditures of earthquake affected Christchurch, and the skyrocketing house prices.

The Kiwi inflation will impact Pacific island countries, including Fiji. All of them import food from NZ, especially meat and dairy products.

Increase in OCR is pushing up the Kiwi dollar, as hot money inflows into NZ seeking higher returns are on the rise. Kiwi and Aussie dollars will soon be on par. Fiji dollar would be depreciating against the Kiwi dollar. That will aggravate import price inflation.

Fiji's monetary authority must be keeping a watch on inflationary trends

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