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Construction Brief

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US Hawks vs NZ Doves

New Zealand's apparent willingness to accept higher inflation could come in handy in the next downturn.

Terminology time! An inflation 'hawk' is a person who is more worried about inflation getting too high. An inflation 'dove' is someone more worried about inflation getting too low.

The US and New Zealand central banks seem to be at the opposite ends of this spectrum at the moment.

The US is increasing interest rates while inflation barely touches their target of 2 per cent. Understandable – they slashed interest rates so dramatically in response to the GFC and have remained so low for so long that they're no doubt eager to bring them back up, lest they spur some unintended imbalances, like an over-inflated stock market or housing bubble. Still though, hawkish.

In NZ, recent economic data is pointing to strength – stronger economic growth, decade-low unemployment of just 3.9 per cent. Both employment and inflation are expected to overshoot their targets on a sustained basis. Inflation is still currently in the middle of their 1-3 per cent target band, but given this strong data there are grounds to expect that they would upgrade their intentions for future interest rates rises. However, they actually appear to quite dovish. Despite the stronger outlook, they give no indication that a rate hike could be on the cards any earlier.

There has long been discussion amongst eminent economists about the appropriate 'target' for inflation. It has been argued that advanced economy central banks may have set their inflation targets too low – the US and UK at 2 per cent, the EU under 2 per cent, Australia 2-3 per cent, NZ 1-3 per cent.

Low inflation targets are understandable given the era when these targets were established. It was during the 1990s, with the high inflation of the 1970s and 80s still fresh in policymakers' minds. They were extra keen to keep inflation under control. It was believed that a 1-3 per cent buffer above zero would be enough to prevent falling into a 'liquidity trap' during a downturn.

The post-GFC era shows that inflation can indeed still get too close to zero – and lower. Current inflation buffers have not negated the dreaded 'liquidity trap'. Inflation became so low that cuts to official interest rates did not provide sufficient additional economic stimulus.

Many advanced economies undershot their inflation targets for most of the last decade. It turns out, getting too close to deflation – let alone actually achieving it – can be hard to reverse.

Some economists contend that we would be better served by higher inflationary targets. They argue that higher inflation targets would be equally effective in maintaining stability but would provide a bigger buffer during economic downturns.

Another way to look at it is that the risks of central bank policy are asymmetric: the costs of allowing inflation to venture a little too high right now are far smaller than the risks of increasing interest rates too fast and driving the economy back into a liquidity trap or worse, a deflationary spiral.

Perhaps this is what NZ's central bank is thinking – an upwards reset of their 1-3 per cent target so they have more inflationary ammunition in the next downturn.

The US is raising interest rates rapidly to keep their inflation rate no higher than 2 per cent. In contrast, NZ is willing to accept higher inflation and raise interest rates more slowly.

If we extrapolate this into the future these two countries will be in vastly different positions. Over the next few years inflation in NZ would be higher and interest rates lower, while in the US inflation would be much lower but interest rates much higher.

Let's say, hypothetically, a major global economic shock causes both the US and NZ to drop their interest rates back down to zero. It would appear the US is in a better position – they would able to drop rates from a much higher level (i.e. more cuts), whereas NZ had a lower interest rate so could not cut rates as much. It could be assumed that the larger cuts in the US would be more stimulatory. However, NZ had a much higher inflation rate before the shock. After the shock inflation would be expected to fall but is likely to remain above zero. In the US, where inflation had been kept very low the deterioration in inflation could see the rate fall back to zero.

This would leave the US dealing with a 'liquidity trap' situation, whereas investment would still be preferable to holding cash in NZ. Ongoing investment in NZ would act to stabilise the economy during the downturn. In the US, the prospect of deflation would create a disincentive to invest and the lack of investment would be an additional headwind exacerbating the downturn.

While this scenario is somewhat arbitrary, it does illustrate that it's not the size of the interest rate cut you have up your sleeve that's important. It's the stimulatory effect of your interest rate position after the cut has been made (i.e. the real interest rate).

I know all of this sounds a bit hypothetical and abstract. But psychology is very important in economics. The perception of being too close to deflationary territory can, by itself, cause an economy to fall into deflationary territory.

Provided that inflation was stable, would it hurt to have a bigger buffer during a crisis?

The fortnight ahead – key dates and releases (AEST)

Wednesday 29 November

HIA Housing Scorecard, 11.00am

ABS Construction Work Done, Preliminary, September 2018, 11.30am

Thursday 29 November

HIA New Home Sales Report, October 2018, 11.30am

ABS Private New Capital Expenditure and Expected Expenditure, CAPEX, September 2018, 10.30am

Monday 3 December

CoreLogic Dwelling Price index November 2018, 9.30am

ABS Building Approvals, October 2018, 11.30am

Tuesday 4 December

RBA Interest rates decision, 2.30pm

Wednesday 5 December

ABS National Accounts (GDP) September 2018 11.30am

Friday 7 December

HIA-AiG Performance of Construction Index, November 2018, 8.30am

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