ANZ Research

RBNZ Monetary Policy Statement Preview

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Hawkeye

Summary

- We expect the RBNZ will raise the Official Cash Rate (OCR) 50bp to 3.00% at its Monetary Policy Statement (MPS) next Wednesday.
- We expect the Committee to strike a hawkish tone in both its choice of words and its OCR track.
- Recent starting point surprises on both domestic inflation and wage growth, as well as recent falls in domestic mortgage rates, give the Committee little choice but to send a clear message.

Straight shooting

It should be a pretty straightforward decision for the RBNZ to deliver another 50bp hike at its Monetary Policy Statement (MPS) next week. On balance, the data flow, while certainly not one-sided, has come in more inflationary than the RBNZ forecast in May. For that reason, one can't rule out a 75bp hike, but this far into the cycle, the RBNZ can deliver the tightening it needs with a 50bp hike, a firm forecast OCR track, and some staunch messaging.

In the July Monetary Policy Review, the Committee noted that it "remains broadly comfortable" with the May MPS OCR track, which showed the OCR peaking at 3.95%. Since then, there have been some 'hawkish' developments:

- Non-tradable CPI inflation at 6.3% in Q2 was well above the RBNZ's forecast of 5.7%. Core inflation measures were all at least 4.8%. This news saw us revise up our own OCR forecast by 50bp; that's our baseline assumption for the impact on the RBNZ's OCR forecasts too.
- QES wages rose 7.0% y/y in Q2 versus the RBNZ's forecast of 5.6%. It's true that the (productivity-adjusted) LCI came in on RBNZ expectations at 3.4% y/y. That's the best measure of the increase in unit labour costs that firms need to pass on. But the QES better captures changes in household income, and the fact is, wage growth of 7% goes a long way to explaining why consumer spending has been holding up reasonably well despite extremely low consumer confidence and rising mortgage rates. It certainly will do nothing to assuage RBNZ fears of a wage-price spiral. How much the RBNZ chooses to make of it is uncertain, but we estimate that it could be worth as much as 50bp on the OCR track.
- Global declines in wholesale interest rates have fed into lower mortgage rates here – counterproductive for the RBNZ, who are trying to engineer tighter financial conditions.

On the 'dovish' side of the ledger:

- Inflation expectations and other surveyed inflation indicators have flattened off, or fallen slightly. It's a start. But they're still far too high.
- Dairy prices are now a chunky 27% off their peak. We don't know what the RBNZ's last forecast assumed for dairy prices, but we suspect recent developments present downside to their starting point for export prices. Depending on how this feeds into their medium-term view, this could be worth perhaps -15bp on the OCR.

- Ongoing COVID disruptions and labour shortages may see the RBNZ revise down their forecast for GDP growth in Q3, but to the extent this is supply-driven, it's inflationary. Further out, we expect the RBNZ will revise down forecast residential and total investment. On net, probably a small negative for the OCR track.
- The USD prices of oil and other hard commodities have eased as global recession fears percolate. The RBNZ assumed a Dubai oil price of USD102/barrel in Q3; it's currently sitting slightly lower at around USD97/barrel. Some measures of shipping costs are easing. A lower imported inflation outlook could knock perhaps 10bp off the OCR track.

In terms of developments that we see as broadly neutral:

- The orderly housing slowdown remains consistent with RBNZ forecasts.
- Both business and consumer surveys remain weak, but so far are overstating the fall in demand (though it's still early days).
- Net migration remains a source of significant uncertainty. Its impact on inflation is also ambiguous, as migrants add to both housing demand and labour supply.

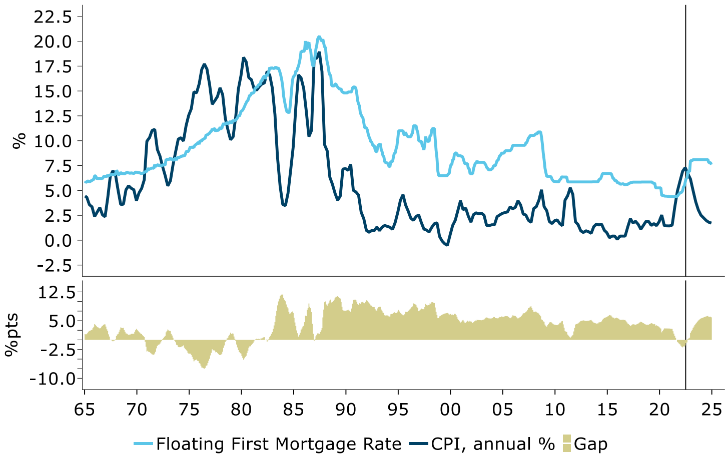
Adding all that up, there are unders and overs, and considerable uncertainty associated with each. And in the end, the published OCR track is subject to a good deal of judgement as well. But it seems likely that the OCR track is going to be revised higher, and potentially by as much as 50bp.

Finding neutral

Non-tradable, core, and wage inflation are all sharply higher versus a year ago – that's sticky inflation that tends to come down only slowly. Certainly, the days of central banks being concerned about undershooting inflation targets are behind us. In that context, the last 10 years may not be long enough when it comes to thinking about how high interest rates might need to go.

One feature of the stable inflation period has been that the floating mortgage rate sat significantly above CPI inflation (figure 2). But currently, the real floating mortgage rate is still negative – and negative real mortgage rates certainly didn't bring inflation down in the 1970s.

Figure 1. CPI inflation and the floating mortgage rate



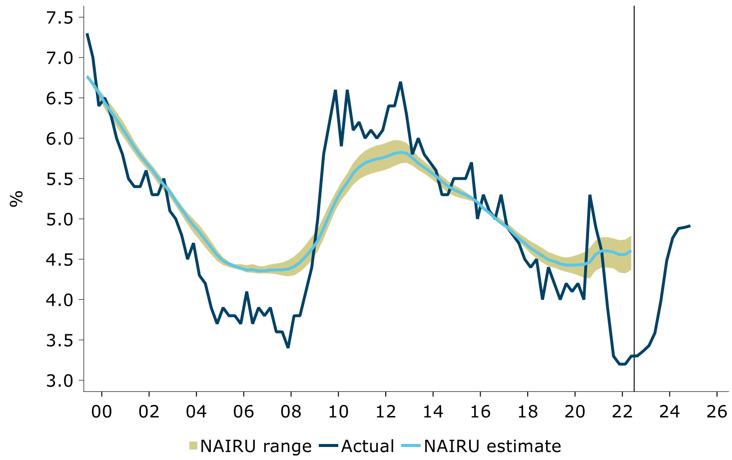
Source: Stats NZ, RBNZ, Macrobond, ANZ Research

Of course, we're forecasting mortgage rates to go up, and CPI inflation to come down, delivering positive real interest rates before long. But it's all contingent on inflation coming down quickly – that's the bit that's doing the work in our forecast. If it doesn't, the OCR will have to keep right on going.

Or, in another possible expression of essentially the same risk: the RBNZ may not be in a position to be able to cut the OCR were a negative growth shock to come along (eg to our terms of trade), depending on how quickly inflation falls in that scenario.

And it's worth noting: despite revising up our unemployment track this week, we are still forecasting that the labour market is going to remain inflationary until 2024. Obviously, forecasts are extremely uncertain. But domestic inflation pressures aren't about to turn on a dime.

Figure 2. ANZ unemployment rate forecasts vs. NAIRU estimate



Source: Stats NZ, Bloomberg, Macrobond, ANZ Research

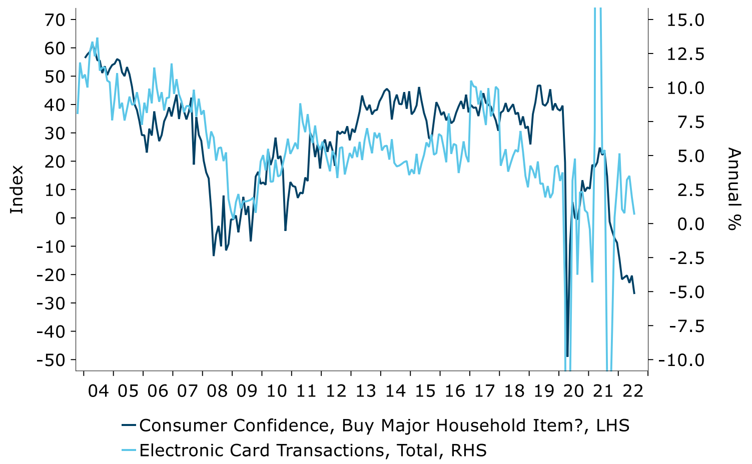
NAIRU: Non-accelerating inflation rate of unemployment

So how contractionary are current interest rate settings?

House prices are down about 7% from their peak so far, with flow-on impacts on construction indicators. So monetary policy is definitely working. But so far, although the spending data is all over the shop (so to speak), it's fair to say that it hasn't slowed nearly as much as dire consumer surveys would suggest (figure 3). Anecdote suggests consumers are certainly reprioritising spending and trimming the sails, but not slamming wallets shut yet.

Of course, monetary policy takes time to feed through the economy. But one thing's for sure: with inflation so high and broad-based, and wages rising fast, under a least regrets framework the RBNZ can't afford to make optimistic assumptions about the degree of effective monetary tightening it is delivering.

Figure 3. Total card spending & Good time to buy major household item?



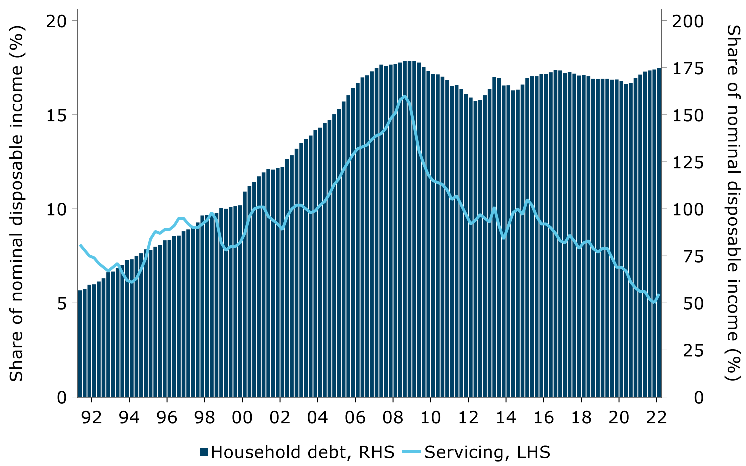
Source: Roy Morgan, Stats NZ, Macrobond, ANZ Research

Neutral interest rates actually move around a lot (well, estimates do – they're unobservable in practice). In 2006, the RBNZ's estimate was over 5%! As the period of above-target inflation and inflation expectations stretches out, one would expect the neutral OCR to creep higher. It is already likely higher than the RBNZ's most recently published estimate of 2%. And looking back over the past 12 months, the rapid increase in wages effectively means the RBNZ has not applied the brakes as hard to household spending power as it thought it had.

A common objection to the idea that interest rates could return to anything like the levels seen in previous cycles is "But debt!" Household debt is high, but it hasn't increased in recent years as much as one might think. While there's been a big wealth transfer between generations that certainly will have consequences, the aggregate household debt to income ratio in Q1 was still slightly below pre-GFC levels. That level of debt caused grief in the following recession, but it didn't stop the OCR getting to 8.25%.

Indeed, household debt servicing is still a fraction of what it was (figure 4). Rather, it's the loopy level of house prices that is likely to be the weak link that limits in practice how high the OCR can go before something breaks.

Figure 4. Household debt and servicing to income



Source: RBNZ, Macrobond, ANZ Research

Markets

Markets are going into this MPS with a very bearish growth mind-set. They seem to be comfortable ignoring problematic inflation themes. In our view, that leaves short-end rates vulnerable to a correction higher, particularly if global rates ratchet higher in the wake of US CPI data on Wednesday night.

At the moment, markets are picking a 3.90% peak in the OCR. That doesn't sound too far out of line given the RBNZ's (and our) current OCR projections. But what is surprising is that markets are assuming that the OCR peaks in February, with cuts thereafter. We think that's plain wishful thinking, and if the MPS plays out as we expect, we can easily envisage bellwether short-end rates like the 2yr edging back towards, and quite possibly beyond, 4% again.

Given the US-centric nature of FX market sentiment, whether a higher OCR track is enough to put the proverbial wind back in the Kiwi's sails again will depend largely on how US markets are faring. However, given the mild moderation in the USD (in DXY terms) since US short-end interest rates peaked, we suspect a hawkish MPS could actually be positive, rather than negative, for the NZD. Even if we do see a mild recession, it's not likely to be accompanied by falling nominal incomes.

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