ANZ Research

RBNZ Monetary Policy Statement Preview

17 May 2023

Contact

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25bp, plus one more for luck in July

Summary

- We expect the RBNZ will raise the Official Cash Rate (OCR) 25bp to 5.50% at its Monetary Policy Statement (MPS) next Wednesday. We see a 20% chance of a 50bp hike and a 5% chance of a pause. Either could backfire by driving down future OCR expectations.
- **We are building one more 25bp hike in July into our own OCR forecast, which would take the OCR to 5.75%.** The (relatively) happy place to sit and "watch, worry and wait" keeps inching just out of reach.
- Data since the April Review has been mixed but firmly tilted to the upside overall, in our view. Downside: the CPI inflation starting point, inflation expectations, LCI wages, and global growth. Upside: soaring migration (the biggie), an earlier floor in house prices, a tighter labour market starting point, slipping fixed mortgage rates, and fiscal policy (probably also a biggie – we'll know more on Thursday – but that's less 'new news' versus the April Review than the migration data is).
- There will be as much art and strategy for the RBNZ in determining the OCR track as science, given the current degree of uncertainty and the number of moving parts. Our best guess is a peak of 5.7% (previously 5.5%), indicating a probable further hike. But if the RBNZ are more worried about housing green shoots and migration than we expect, they could signal a peak closer to 6%. Whatever the suggested peak for the OCR, the RBNZ is very unlikely to corroborate market expectations of cuts by early next year.
- We expect a relatively firm tone from the RBNZ, but also words that leave all doors open depending on how the data evolves from here, which could be up, down or sideways relative to their expectations.

More surprises in store?

Previewing the Reserve Bank OCR decision feels a little fraught after the RBNZ surprised observers with a 50bp hike last month, when a smaller move had been universally anticipated by domestic analysts. In explaining the decision, the RBNZ pointed to:

- Upside risks to inflation from the floods/cyclone (eg food prices).
- Upside risks to inflation from the fiscal outlook, including the rebuild.
- a desire to see retail fixed-term lending rates hold up, and retail deposit rates lift, in the face of falling wholesale rates.

The RBNZ noted in April that while "the economy is starting from a slightly weaker position than assumed in the February Statement", nonetheless, "in aggregate, economic projections were little changed". From that, we take that the weaker GDP starting point and bigger cyclone/flood rebuild estimates roughly cancel each other out in the RBNZ's view, and that the February MPS 5.5% forecast OCR peak is the appropriate baseline for considering the economic news over the past six weeks.

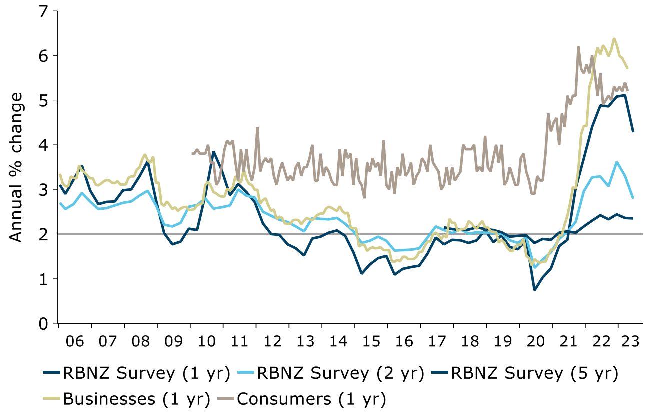
So, what is the "new news" since April?

Inflation. The RBNZ noted in April that the path of core inflation and inflation expectations "will determine the direction of future monetary policy."

Q1 CPI data were mixed, but overall the release was clearly good news relative to RBNZ expectations. Both headline (6.7%) and non-tradable inflation (6.8%) came in lower than the RBNZ was anticipating (7.3% and 7.1% respectively), while obviously still far too high. Some measures of core inflation fell slightly, but some went higher.

Inflation expectations. Neither ANZBO nor consumer measures have moved much, but there was a chunky fall in the RBNZ's quarterly survey measures (figure 1). The two-year-ahead measure fell back into the target band, down from 3.3% to 2.79%. This (small) survey has a good number of professional inflation forecasters in it, and in that light, it isn't surprising that the 0.5%pt fall is similar in magnitude to the downside surprise to the Q1 CPI starting point (6.7% y/y versus a median market expectation of 7.1% y/y).

Figure 1. Measures of inflation expectations

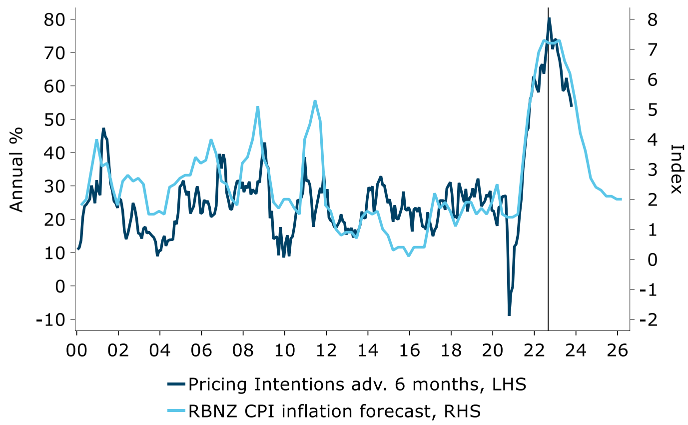


Source: RBNZ, Roy Morgan, Macrobond, ANZ Research

While one must be careful to not effectively double count the CPI surprise, by doing what it should be doing, the expectations data will go some way to allaying RBNZ concerns that expectations might prove sticky, driving up the neutral OCR. The next test is whether broader business and consumer expectations follow suit and drop more markedly than they have so far.

Meanwhile, pricing intentions continue to ease – in line with RBNZ February CPI forecasts (figure 2). Again, it reduces an upside risk rather than informing the central forecast.

Figure 2. ANZBO pricing intentions vs. RBNZ February CPI forecast



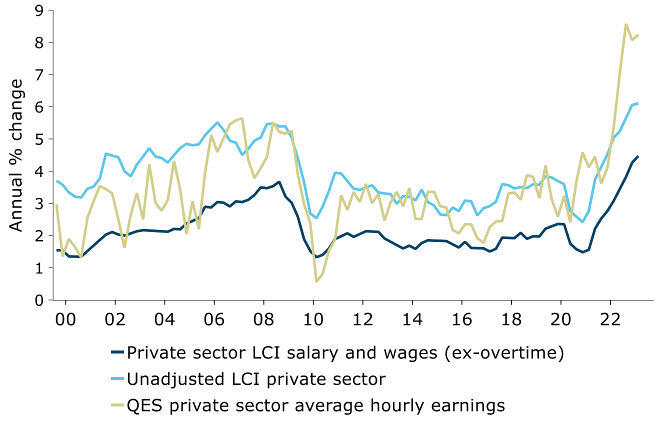
Source: RBNZ, Macrobond, ANZ Research

Together, we estimate that the range of inflation starting point and pricing momentum data since the April Review is worth perhaps 25bp off the RBNZ's published OCR track (in isolation).

Labour market. Q1 labour market data showed that it remained extremely tight in Q1, despite strong labour force growth. We'd characterise the data as pent-up demand for workers finally being met; the strength won't necessarily persist for long. Overall, though, the starting point for the labour market is a bit stronger than the RBNZ was expecting.

More helpfully, from the RBNZ's perspective, inflation in the Labour Cost Index (4.5%) came in a little lower than they had anticipated (4.7%). Admittedly, the same can't be said for wages in the Quarterly Employment Survey, the better measure of the change in households' cash-in-hand wage income. That rose 8.2% versus RBNZ forecasts of 7.6% y/y.

Figure 3. LCI and QES wage inflation

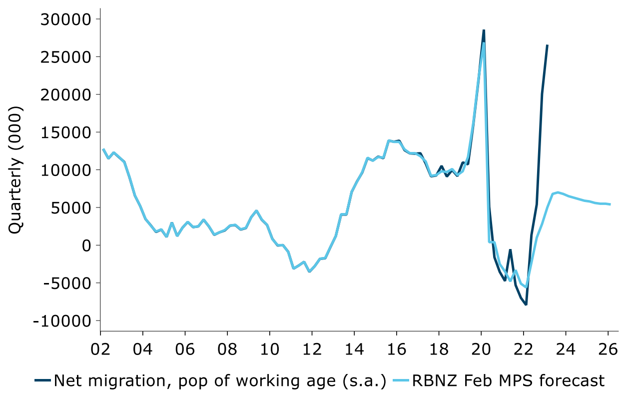


Source: Stats NZ, Macrobond, ANZ Research

Overall, we estimate that the labour market starting point and wage data could be worth a lift of anything from 5-20bps to the OCR track, depending on how long the RBNZ expects the strength to persist.

Net migration. Immigration is storming. The RBNZ in February assumed net migration (aged 15+) of 25,600 for all of 2023. We've seen that in the first three months of the year alone.

Figure 4. Net migration of working age vs. RBNZ assumption



Source: Stats NZ, Macrobond, RBNZ, ANZ Research

What the RBNZ makes of this data is the massive question mark hanging over this Monetary Policy Statement.

The RBNZ might downplay it, pointing out:

- It might be wrong – the data is subject to large revisions.
- Arrivals might peter out soon. And/or many of these migrants might leave again before too long – it's really unusual to have immigration soaring just as labour demand weakens.
- Higher labour supply will dampen wage pressure and hasten the turn of the labour market.

On the other hand:

- Even if the RBNZ assumes arrivals are about to drop sharply, they're looking at a massive upward revision to their previous forecasts.
- The housing market is already showing signs of life, and immigrants add to housing demand (and demand more generally). The wealth effects of house prices going modestly higher may not be huge, particularly if unemployment is starting to creep higher. But when the RBNZ is imploring consumers to "cool their jets", tolerance for any housing market pick-up is likely to be very limited.
- The relative impacts on demand and supply (and their timing) will depend on details about the mix of immigrants and emigrants that are poorly understood in real time. The RBNZ's own research has indicated that despite offsetting impacts on supply and demand, overall, strong net migration tends to be inflationary, at least for a time. Consistent with this, the RBNZ talked in the April Monetary Policy Review about rising net migration as a upside risk to medium-term activity and inflation.

So, we can be pretty sure that the migration data is going to be an upward influence on the OCR track. But how big? We have no way of knowing how fast the RBNZ will assume net migration drops away, nor the forecasting model's calibration of its impacts. The model could spit out a huge number, but we guesstimate Committee judgement will limit the impact in this MPS to something in a 0-30bp range.

Fiscal policy. This was identified as an upside risk at the April Review. As we outlined in our Budget Preview, we expect a return to surplus to be pushed out a year, with the flood/cyclone rebuild boosting overall spending despite some reprioritisation. It's impossible to know what that's worth in terms of OCR basis points, but it's clearly positive, and could be significant. Whether fully encapsulated in these RBNZ forecasts or not, expansionary fiscal policy is an upside risk to the ultimate OCR peak.

In other news since April:

- Business sentiment and activity indicators haven't moved much. But the PMI and PSI are weaker.
- Consumer spending is weakening, but not falling off a cliff.
- The NZD trade-weighted index is back around the Feb MPS assumption. The Dubai oil price has dropped to USD75 versus an RBNZ assumption of USD86.7 for Q2. Offsetting that, the fuel tax subsidy is being removed, which will add 0.5% to headline CPI in Q3 (not that that is new news).
- 3-year fixed mortgage rates have eased further.
- The RBNZ is easing LVR restrictions. That could hasten the turn of the housing market. There's certainly unmet demand for high-LVR lending from first home buyers. Investors, not so much, as long as interest payments remain non-deductible.

Weighing it all up

Uncertainty is particularly marked at the moment. The picture was already clear as mud, and now booming migration has joined the fray. That, plus the game of cat and mouse with a market that is bored with hikes and impatient to move on to cuts, means strategic considerations could play a fairly significant role in both the OCR decision and choosing the OCR forward track to publish. How best to keep the pressure on without losing your (sceptical) audience?

First, the **OCR decision** itself. Despite the uncertainty, or even because of it, a 25bp hike seems a likely choice this time. First up, it's what they said they thought they would do. Second, monetary policy is working, as you would expect after 500bp of hike in 18 months! At this stage, with the economy cooling and the OCR estimated to be well into contractionary territory, scramble should be giving way to nuance.

We see a pause as unlikely because the data on balance warrants an upgrade to the RBNZ's estimate of the degree of tightening required. A pause would equate to a downgrade, given a 25bp hike at this meeting was previously signalled. In addition, it would risk a slump in future OCR expectations and hence fixed mortgage rates, at a time the housing market is turning upward. We see the odds of a pause as around 5%.

On the other hand, a 50bp hike could backfire, in that it could see the market decide the RBNZ has 'definitely' overdone it. The market might price cuts more aggressively, making the net impact of the hike on monetary conditions ambiguous. We see the chance of a 50bp hike as around 20%.

What about the **OCR track**? We estimate that the developments since April warrant a lift. Indeed, we suspect the raw model run might spit out a startling number – on data alone the RBNZ could justify a peak of 6%. But there's no need to bake all upside risk into the central track when there are clearly still downside risks too – the economy and inflation could be turning south faster than estimated, and the same risks apply to global growth. An appealing strategy might be a track that suggests one more hike, followed by "watch, worry and wait" with the OCR at 5.75%. A track peaking around 5.7% with no cuts until the second half of next year would be consistent with that.

The market is keen to price in cuts, and soon, but it's worth remembering the 2007-08 experience. The RBNZ paused for six months – then hiked twice more. Paused again for over a year – then hiked four more times. A pause is not necessarily a peak. During the pause the RBNZ will be no less data dependent for the fact that they didn't move the OCR at the last meeting.

Downside risks are well understood – and they have not gone away. But they remain in the "cross that bridge when we come to it" basket, whereas the RBNZ cannot "hope for the best" with upside risks from this starting point. We expect a relatively firm tone from the RBNZ, but also words that leave all doors open depending on how the data evolves relative to their expectations: up, down or sideways.

As for **our own OCR forecast**, we have been talking for some time about upside risk to our forecast peak of 5.5%. The latest migration data and the exercise of laying all the pieces out on the table has nudged us over the line to put one more 25bp hike in our central forecast, which would take the OCR to 5.75%. Our base case is that that is delivered at the next meeting in mid-July.

To those who argue that this is overkill and will all end very badly; it well might. Tighter monetary policy is working and the RBNZ can see that. But the upside risks to inflation just keep coming and demand centre stage, pushing the downside risks to the wings, where they lurk, muttering darkly.

Markets

As discussed above, we see a 25bp hike as very likely, but would see another 50bp hike as much likelier than a pause. Yet market pricing is skewed (albeit very mildly) towards a pause, with a hike of only 23bps priced in this morning. That implies we'll see a mild lift in short-end rates on a 25bp hike, and a big lift on a 50bp hike. Bill rates would get a bigger shock from a larger hike, but if we get the 25bp hike we expect, bill rates won't move far.

The bigger consideration for the market is the RBNZ's tone and what happens to their OCR track. As noted, we think the RBNZ lifts the track, and potentially by quite a lot, but markets don't buy it and are instead banking on a couple of cuts by next May. This is where we see the biggest upside risk, and it'll come through 1 and 2yr wholesale rates, as they are the most sensitive to assumptions around the so-called terminal rate. As at this morning, the markets are banking on a 5.57/5.58% peak in July/August, with cuts priced in thereafter, so clearly a track that is raised and/or stays higher for longer than just a few months poses upside risks to wholesale rates.

The tone and track are so important that we'd go so far as to say that we suspect a 25bp hike and a more hawkish tone and track would be more effective than a 50bp hike at keeping the yield curve up (if that's the RBNZ's objective). A bigger hike would jolt the market, but as we saw in April, it'd also feed recession fears and may result in a more inverted yield curve, adding downward pressure to key medium-term wholesale rates like the 3-year, which is the new "battleground" in the mortgage space.

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