ANZ Research

RBNZ Monetary Policy Statement Review

16 August 2023

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Wheels slipping a little?

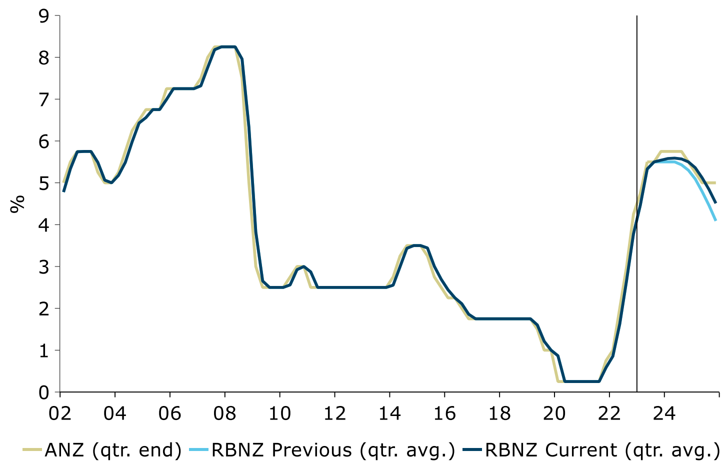
Summary

- As expected, the RBNZ left the Official Cash Rate (OCR) unchanged at 5.50% today. However, the peak OCR forecast was lifted from 5.5% to 5.59%. As before, cuts are pencilled in for the second half of 2024.
- The outlook for growth and inflation is little changed in the forecast beyond the very near term. The lift in the track is related rather to a 25bp lift in the estimate of the neutral OCR over the projection, implying that the RBNZ does not perceive current OCR settings to be quite as contractionary as it did three months ago.
- Although the Governor was at pains to downplay the small lift in the OCR track as any kind of signal as to the likelihood of future moves, it was a small but clear step in the direction of further hikes. We continue to forecast a 25bp hike in November.
- However, ironically, the tweaks to the RBNZ's near-term forecasts (lower unemployment, higher non-tradable inflation) raise the bar for upside surprises that could prompt a restart to hiking. Accordingly, we would characterise the risks as tilted towards hikes kicking off later (ie February) – but note that a later start means more required, all else equal. As before, our forecast for a further hike is predicated on no global sideswipe. China's economic outlook tops that risk list currently.

In brief

As expected by both analysts and the market, the RBNZ today left the Official Cash Rate (OCR) unchanged at 5.50% with a balanced tone. However, the lift in the OCR track in the Monetary Policy Statement is small but unambiguously in a hawkish direction. It should be noted that the Governor downplayed this interpretation at the press conference. As before, cuts are pencilled in for the second half of next year, but slower, with the OCR back down to 3.76% by mid-2026 (previously 3.31%).

Figure 1. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

Key quotes:

- **OCR outlook:** "Conditional on our central economic outlook, it is expected that the OCR will need to remain near its current level for slightly longer than assumed in the May Statement."
- **Labour market:** "Employment is above its maximum sustainable level, however, recent indicators show that labour market pressures continue to ease."
- **Domestic activity:** "Members noted that current projections are for subdued GDP growth, rather than a sharp downturn."
- **Inflation outlook:** "Overall, inflationary pressure in the economy is slightly higher than assumed in the May Statement."
- **Housing market:** "Members agreed that the current projection for house prices was reasonably balanced, remaining around estimates of sustainable levels."
- **Global activity:** "Over the medium term, the Committee discussed risks around the outlook for global growth and judged that these were skewed to the downside."
- **Global inflation:** "Global inflationary pressures are easing, which is expected to result in lower imported inflation in New Zealand."

Waiting and seeing remains a very defensible strategy in a time of such uncertainty. Unfortunately, rather than resolving, the outlook is currently getting murkier, if anything, with risks on both the upside and downside threatening to crystallise.

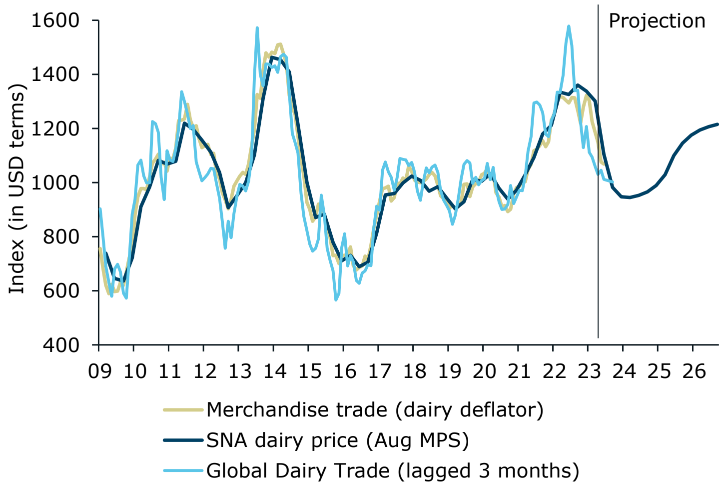
Upside risks to inflation noted by the RBNZ included near-term upside risks to inflation expectations and a slower easing in the labour market. To that list we'd add the possibility that the RBNZ's upwards revision to their neutral OCR assumption isn't enough, meaning a higher OCR required to get the same amount of easing in inflation. Indeed, our base case is that domestic inflation pressures will not abate as rapidly as the RBNZ is assuming, due to relative resilience in the labour market in particular.

In terms of **downside risks**, the RBNZ talked about the global outlook, unsurprisingly, and risks about China in particular. Cautious consumers and a construction slowdown are impacting prices for New Zealand's key commodities including dairy, meat and logs. But the RBNZ's terms of trade forecast was little changed from May's relatively bearish outlook. The RBNZ's export price forecast was revised down slightly, but so were import prices.

There was another sharp decline in global dairy prices overnight. The RBNZ's forecasts assume that we are near the bottom (figure 2, over). There's clear downside risk around that.

Risks around the lagged effect of previous monetary tightening on households and businesses also appear front of mind, but this one cuts both ways.

Figure 2. RBNZ dairy price forecast



Source: Stats NZ, Global Dairy Trade, RBNZ estimates

RBNZ forecasts in brief

In the very near term, the RBNZ has lowered its Q3 forecast for the unemployment rate from 4.1% in May to 3.8% (ANZ 3.9%), suggesting the hurdle to a November hike on the back of this piece of data is now higher (given the RBNZ deem this forecast consistent with an on-hold OCR). Meanwhile, the Q3 non-tradable inflation forecast has been lifted from 1.4% q/q in May to 1.7% q/q. That increases the odds that the RBNZ will hike again in time, all else equal, but raises the bar for it being as soon as November, insofar as hawkish surprises relative to those forecasts become less likely. Meanwhile, recent GDT auction results suggest there is immediate downside risk to their dairy price assumption – also suggesting a higher hurdle to a November hike. On the other hand, the OCR track was unexpectedly lifted! At the end of the day, the data will determine what the Committee does, and they always reserve the right to change their minds. In terms of our own forecasts, we've left the resumption of hiking in November, for now, but overall see today's Statement as tilting the odds towards it being delivered a little later.

Turning to the medium-term forecasts, only small tweaks have been made at the margin, with the GDP and CPI outlook little changed and unemployment expected to peak just 0.1%pt lower than previously (at 5.3%). See page 8 for forecast comparisons.

All up, these forecasts really aren't that different to the May MPS, after the starting point is taken out.

As expected, the RBNZ revised up their house price track considerably, to be similar to our own. In terms of consequences, the Committee played them down, also as anticipated:

- the earlier-than-expected stabilisation in house prices, … is assumed to support household consumption over the next three years."
- "However, members agreed the willingness to consume out of wealth can vary and may be lower in the current context of high debt servicing costs."

Our take

The RBNZ's commentary on the economy and the inflation outlook was little changed from July, as expected, with unders and overs in the data and news flow since then. However, at the end of the day, the Committee signed off an OCR track that peaks 9bp higher and suggests a higher OCR for longer than their previous forecasts. That's a clear tilt in the hawkish direction. While the neutral OCR estimate might be 'technical', at its heart, it gets to the key reason why we are forecasting that sooner or later the RBNZ will be drawn back to the hiking table: higher inflation is gradually becoming more embedded in borrowing, pricing and wage decisions.

We very much agree with the RBNZ's forecasts for the big picture: the economy is slowing, the export outlook is challenged, unemployment is set to rise, and inflation is cooling. Where we diverge continues to be on how quickly the labour market will loosen and how rapidly domestic inflation will dissipate, though given the RBNZ's near-term forecasts tweaks, the divergence might not be clear by year-end.

There are risks out there that could make such nuances completely irrelevant, were they to change the economic outlook markedly. China is one, and we'd add global risk pricing, which remains remarkably benign. But as long as the economy doesn't get sideswiped (which in practice does tend to be how New Zealand business cycles end), we continue to see the RBNZ brought back to the hiking table in time.

Financial markets

We think today's pause was a little more hawkish than most market participants expected, mostly on account of upward revisions to the RBNZ's OCR projections. Commentators at the hawkish end of the spectrum (including us) had suggested that the RBNZ may extend the 5.5% OCR peak for a quarter or two, but few if any thought the RBNZ would lift their track. It was therefore not surprising that swap rates moved up slightly after the decision.

With the peak in the RBNZ's profile (5.59% in June 2024) on a par with where the market saw the peak going into the decision (5.59% in February), it's mainly timing that separates the market from the RBNZ. Stepping back, the main theme markets should be taking from the MPS is one of 'higher for longer'. All else equal, that's likely to exacerbate the recent tendency for markets to 'price out' some of the easing over 2024 that has been priced in, keeping pressure on short to medium-term interest rates. Negative carry has been a concern in the swap market for a while (3mth BKBM set today at 5.64%, but 2 and 3yr swap rates are at around 5.54% and 5.25% respectively), and we think today's higher OCR track and upward revisions to where the RBNZ sees neutral will do little to allay those fears.

Currency markets reacted positively to the MPS, with the Kiwi up around 30bp immediately. Higher rates are a potential leg of support for the ailing NZD, but they pale in comparison to global concerns that are feeding the risk-off vibe in markets, and the RBNZ's tone is unlikely to materially alter the path of the NZD.

Official Cash Rate remains at 5.5%

The Monetary Policy Committee today agreed to maintain the Official Cash Rate (OCR) at 5.50%.

The current level of interest rates is constraining spending and hence inflation pressure, as anticipated and required. The Committee agreed that the OCR needs to stay at restrictive levels for the foreseeable future to ensure annual consumer price inflation returns to the 1 to 3% target range, while supporting maximum sustainable employment.

The New Zealand economy is evolving broadly as anticipated. Activity continues to slow in parts of the economy that are more sensitive to interest rates. Labour shortages are easing as overall demand softens and immigration adds to labour resources. Headline inflation and inflation expectations have declined, but measures of core inflation remain too high.

Globally, economic growth remains below trend and headline inflation has eased for most of our trading partners. Core inflation remains high in many countries. Weakening global economic growth is putting downward pressure on New Zealand export prices.

The imbalance between demand and supply is moderating in the New Zealand economy. However, a prolonged period of subdued spending growth is still required to better match the supply capacity of the economy and reduce inflation pressure.

In the near term, there is a risk that activity and inflation measures do not slow as much as expected. Over the medium-term, a greater slowdown in global economic demand, particularly in China, could weigh more on commodity prices and overall New Zealand export revenue.

The Committee is confident that with interest rates remaining at a restrictive level for some time, consumer price inflation will return to within its target range of 1 to 3% per annum, while supporting maximum sustainable employment.

Summary record of meeting

The Monetary Policy Committee discussed recent developments in the New Zealand economy. The Committee agreed that monetary conditions are restricting spending and reducing inflationary pressure as anticipated. While supply constraints in the economy continue to ease, inflation remains too high. Spending needs to remain subdued to better match the economy’s ability to supply goods and services, so that consumer price inflation returns to its target range.

Global economic growth remains below trend for most of our trading partners. While global growth was resilient across the first half of the year this is beginning to fade, particularly in China. Globally, headline inflation has declined but core inflation remains high in many countries. The Committee noted that regional divergences in the moderation of core inflation are beginning to emerge.

New Zealand’s export volumes over the last quarter were more resilient than expected due to favourable agricultural growing conditions in some regions. However, export revenues are expected to ease, in line with weakening global demand. A decline in global commodity prices has seen prices for New Zealand’s exports moderate.

The Committee noted that tight monetary conditions continue to constrain domestic spending. The slowdown in economic activity is most notable in the parts of the economy that are more sensitive to interest rates. The

Committee judged that with monetary conditions remaining restrictive, they expect to see further declines in consumption per capita and for GDP growth to be subdued over coming quarters.

Annual CPI inflation declined to 6.0% in the June quarter, with tradables inflation declining more than non-tradables inflation. Most measures of inflation expectations have declined alongside the fall in headline inflation. However, measures of core inflation remain near their recent highs.

The Committee discussed the labour market and agreed that capacity pressures have begun to ease. Recent net immigration has increased labour supply, helping to alleviate some labour market shortages. Employment growth remains resilient. The Committee noted that most measures of annual wage inflation have begun to ease.

The Committee noted that the estimate of the nominal neutral OCR has increased by 25 basis points to 2.25% within the projections, consistent with the Reserve Bank's indicator suite. The Committee agreed that the current level of the OCR remains contractionary and is constraining domestic spending as needed.

The Committee discussed the increase in the current account deficit and noted that this is primarily due to reduced services exports stemming from the COVID-19 pandemic as well as excess domestic demand. The current account deficit is expected to steadily narrow. Members noted that net foreign liabilities have declined over recent years and that risks associated with funding the deficit were low, as most foreign debt is hedged against foreign exchange risk.

The Committee discussed the recent strong growth in net immigration. The overall impact on demand and inflation pressure remains uncertain. Members noted that the current increase in net immigration may be less inflationary than previous increases, due to both changes to the composition of migrants and in the context of a tight domestic labour market.

The Committee noted that house prices appear to have stabilised. Members agreed that the current projection for house prices was reasonably balanced, remaining around estimates of sustainable levels. The Committee agreed that house price changes have an impact on household wealth. However, members agreed the willingness to consume out of wealth can vary and may be lower in the current context of high debt servicing costs.

The Committee discussed the balance of risks for inflation, output, and employment. Members noted that current projections are for subdued GDP growth, rather than a sharp downturn.

In discussing near-term risks, members considered upside risks to activity and inflation. Members discussed the impact of recent administered price increases – for example, council rates and excise tax – on headline inflation for the September quarter and noted that this could pose a risk to inflation expectations. Members also discussed risks around a slower easing in the labour market resulting in wage inflation taking longer to decline.

The Committee noted that the projections for government expenditure and revenue are predicated on Budget 2023 forecasts. Overall, real government consumption and investment spending as a share of potential GDP is projected to decline over the forecast horizon.

Over the medium term, the Committee discussed risks around the outlook for global growth and judged that these were skewed to the downside. A greater slowdown in global growth would likely see a fall in import prices.

Members noted that weaker global demand, particularly from China, could weigh further on commodity prices and therefore on export revenues.

Members also discussed the risks around the lagged effect of previous monetary tightening on households and businesses. The average mortgage rate on outstanding loans is expected to rise from around 5% to near 6% by early 2024, and debt servicing costs as a share of income are still increasing.

Members discussed the risk to those parts of the economy most exposed to lower commodity or asset prices. The Committee agreed that the slowdown in economic activity will not be even across sectors of the economy, due to global factors and the varied impact of high domestic interest rates. In particular, the Committee noted that pockets of stress were beginning to emerge for some households, and the commercial property, agriculture, and construction sectors.

The Committee agreed that in the current circumstances, there is no material trade-off between meeting the Committee's inflation and employment objectives and maintaining the stability of the financial system. Members noted that debt levels are high in some parts of the economy and debt servicing costs have increased. While broad indicators of stress have increased, non-performing loans remain at low levels.

In discussing their Remit objectives, the Committee noted inflation is still expected to decline within the target band by the second half of 2024. The Committee agreed that the risks around the inflation projection remain balanced. Employment is above its maximum sustainable level, however, recent indicators show that labour market pressures continue to ease.

The Monetary Policy Committee discussed the appropriate stance of monetary policy. The Committee agreed that interest rates still need to remain at a restrictive level for the foreseeable future, to ensure annual consumer price inflation returns to the 1 to 3% target range while supporting maximum sustainable employment.

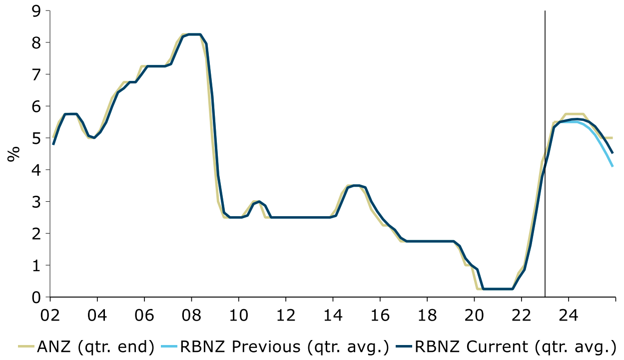
On Wednesday 16 August, the Committee reached a consensus to maintain the Official Cash Rate at 5.50%.

Attendees:

Reserve Bank members of MPC: Adrian Orr, Karen Silk, Christian Hawkesby, Paul Conway
External MPC members: Bob Buckle, Peter Harris, Caroline Saunders
Treasury Observer: Dominick Stephens
MPC Secretary: Kate Poskitt

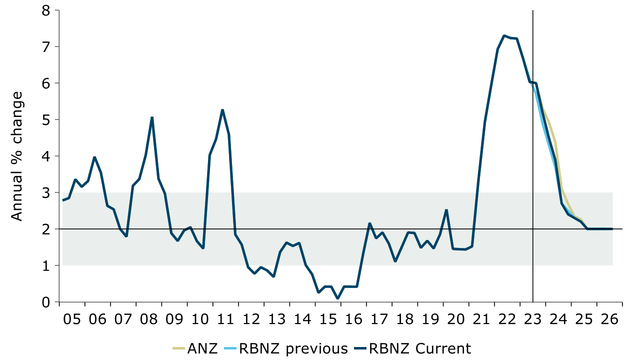
Key forecasts: Small tweaks vs May

The RBNZ lifted its peak OCR guidance marginally reflecting a higher neutral assumption…



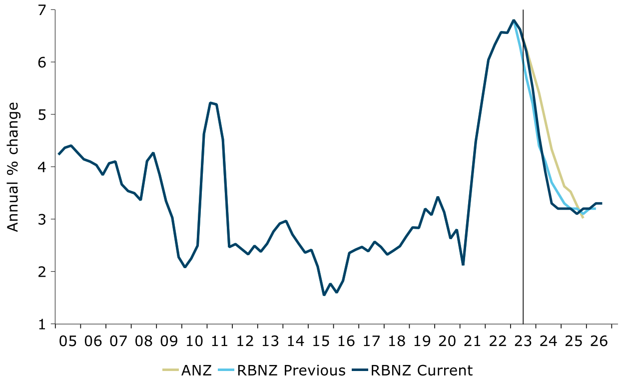
Source: RBNZ, Macrobond, ANZ Research

…meaning more work to achieve roughly the same CPI inflation outturns

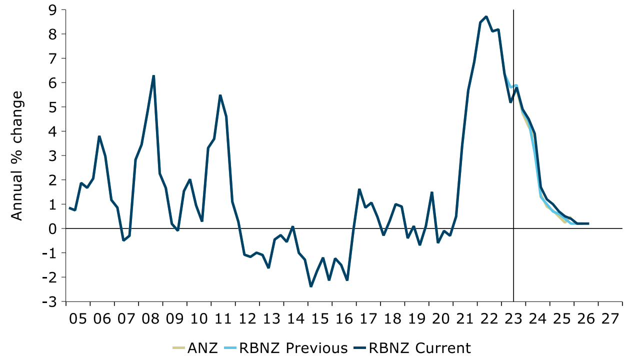


Source: RBNZ, Stats NZ, Macrobond, ANZ Research

…with both the non-tradables…

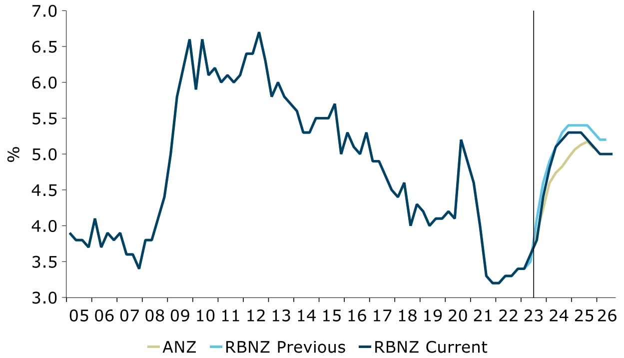


…and tradables outlook little changed



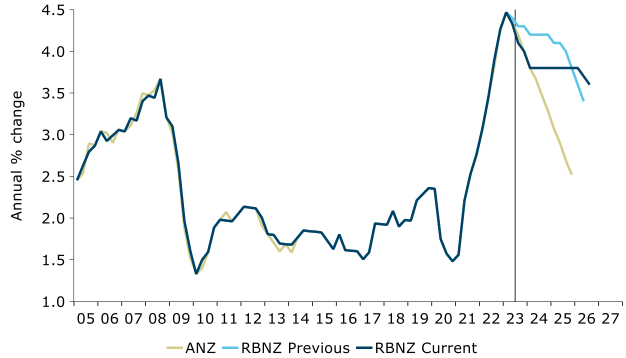
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

The unemployment rate peaks at 5.3%, 0.1%pts lower than previously



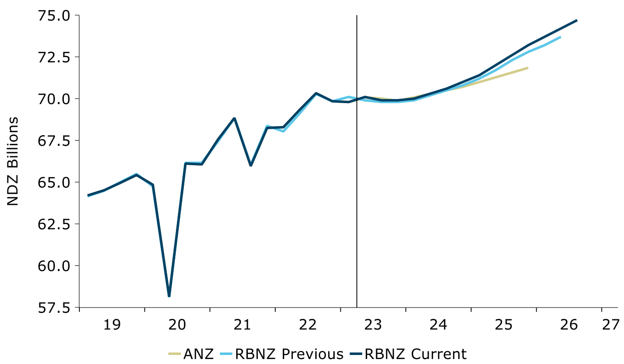
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

LCI wage growth peaks lower, but stays high for longer. Why no boost to non-tradable inflation?



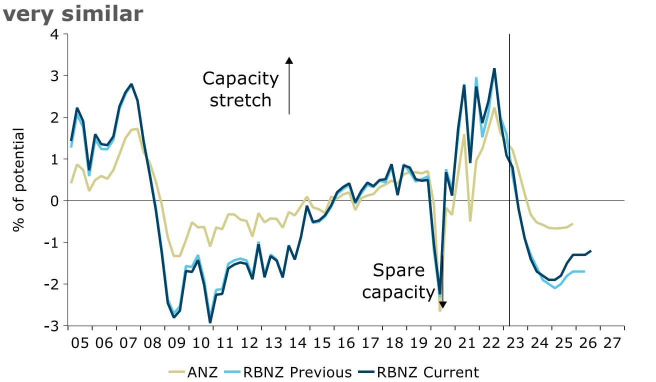
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

Medium term GDP forecasts are little changed…



Source: RBNZ, Stats NZ, Macrobond, ANZ Research

…with the outlook around spare capacity (output gap) very similar



Source: RBNZ, Macrobond, ANZ Research

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Last updated: 18 April 2023

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