ANZ Research

RBNZ Monetary Policy Statement Review

29 November 2023

Contact

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When hawks fly

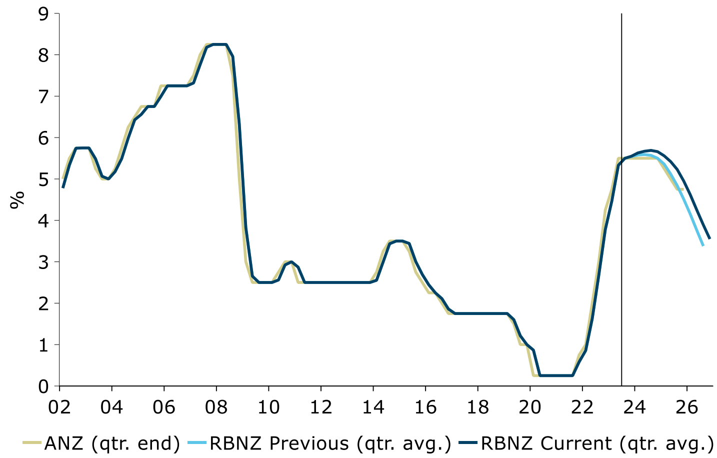
Summary

- As expected, the RBNZ left the Official Cash Rate (OCR) unchanged at 5.50% today. However, in a surprise to the market, the forecast peak OCR was raised from 5.59% to 5.69%. Cuts are pencilled in for late-2024, with similar timing to before.
- The hawkish tilt comes despite recent data that on balance has gone the RBNZ's way, particularly the labour market. Part of it may be strategy, talking tough to prevent the market running away with the idea of cuts and thereby easing monetary conditions, but there does appear to be genuine concern that the bulk of the transmission of monetary policy is now in the rear-view mirror and core inflation and inflation expectations have not responded as hoped.
- We still very much see the risks around the OCR as two-sided from here. Data on the labour market and inflation expectations will be particularly important to watch over the long summer break.

In brief

As expected by both analysts and the market, the RBNZ today left the Official Cash Rate (OCR) unchanged at 5.50%. However, that does not mean it was a non-event by any means. The main interest for the market today was not the decision, insofar as that was seen as a done deal, but rather whether the peak in the forecast OCR track would be lowered, as well as any hints in the forecasts and the text about when the RBNZ expects to start reducing the OCR. But in fact, the OCR track was *raised* by 10 points to a peak of 5.69% by mid next year, which effectively shifts the burden of proof to reasons *not* to hike from here. The market was taken by surprise, and swap rates have jumped considerably.

Figure 1. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

Key quotes:

- **OCR outlook:** "Members discussed the possibility of the need for increases to the OCR. Members agreed that with interest rates already restrictive, it was appropriate to wait for further data and information to observe the speed and extent of easing in capacity pressures in the economy."
- **Policy transmission:** "We believe most of the recent monetary tightening is already having its peak effect on inflation. This does not mean that transmission is complete, only that the impacts are unlikely to get much larger over time."
- **Labour market:** "Members noted that whilst pressures in the labour market are easing, it is still tight, and employment remains above its maximum sustainable level."
- **Domestic activity:** "While growth in parts of the economy is slowing, there has been less of a decline in aggregate demand growth than expected earlier in the year."
- **Inflation outlook:** "Some members noted that inflation has now been above target for some time, and that there should be a low tolerance for any increase in the time to return inflation to target."
- **Housing market:** "Some members considered that the willingness of households to consume out of wealth may be lower given recent house price falls, higher debt servicing costs, and a softening labour market. Other members considered that there may be upside risks to house prices, and therefore consumption, given the anticipated decline in residential investment."
- **Global activity:** "Internationally, economic growth has been stronger than was expected at the start of this year but remains below trend and is likely to slow further."
- **Fiscal policy:** "The Committee noted that the incoming Government's policy programme will have implications for economic activity and inflation."

Overall the tone of the above quotes and indeed the MPS as a whole, was more hawkish than we or the market had expected. Of course, the RBNZ has carefully maintained its optionality; it remains in data-watch mode, which was always where things were ultimately going to land. Market expectations regarding the direction of policy from here will wax and wane with the data flow. The RBNZ has put themselves in a fairly comfortable position to ride those waves: the odds of mortgage rates falling over the summer just reduced significantly, which we suspect was one of the RBNZ's goals today, buying them time to see how the data pans out before tolerating an easing in monetary conditions.

As always, the RBNZ were at pains to outline risks to the outlook on both sides. According to the Summary Record of Meeting, these are 'broadly similar' to that discussed in the August meeting, but with some prior upside activity risks now centralised into the forecast. Two risk scenarios were discussed by the committee:

- An upside inflation scenario, with "persistent domestic demand strength supported by strong population growth, with increases in rents and aggregate consumption feeding into greater inflationary pressure and higher house prices".

- A downside scenario, including “a larger global economic slowdown, with growth below trend for longer than currently anticipated. A greater slowdown in global growth would see a fall in the price of imports and further reduce goods export prices and export volumes”.

Changes to fiscal policy settings (which were less directional), El Niño, China’s economy, and geopolitical tensions also got a specific nod regarding risks to the outlook. Out of the four on this list, we’d say only the one that represents an upside risk to inflation is higher energy prices on the back of geopolitical tensions.

Whether and how these risks play out will determine whether the RBNZ ends up hiking again and ultimately when cuts can occur.

RBNZ forecasts in brief

While the RBNZ’s activity forecasts were not particularly different from those published in August, it’s what’s under the surface that matters, the RBNZ’s estimates for the unobservables: the neutral OCR and the output gap.

The estimate of the neutral OCR was revised up another 25bp. We certainly agree that their estimate was on the low side (not least because it’s based on an assumption of a neutral real rate of 0%) but given recent data has more clearly illustrated the impact of monetary policy, we didn’t think they’d reassess neutral in these forecasts.

And as regards the output gap, the RBNZ put a lot of the Q2 GDP miss into the output gap, ie the demand side of the economy rather than supply. This was a surprise, as in the October Review the RBNZ downplayed that data, noting that immigration explained some of it and “demand growth in the economy continues to ease broadly as expected.” But in the end, the RBNZ made a substantial upward revision to their medium-term output gap assumption (see charts on page 10), which implies that they are assuming that inflation requires less slack in activity to return to target – and noting that as a risk.

Indeed, the Committee has taken a hawkish interpretation of recent activity data across the board, noting that “factors adding to inflationary pressure include higher starting-point growth momentum, a stronger recovery in house prices, increases in projected government investment, higher global interest rates and an upward revision to the neutral OCR. These are partially offset by lower import and export prices”.

In terms of the specific forecasts for observable data, the RBNZ revised up their Q4 inflation forecast a touch from 0.7% to 0.8% in Q4 (ANZ 0.6%), with a small upward revision to their expectation for non-tradable inflation. However, they retained a similar medium-term inflation profile, with inflation returning to the target band in Q3 2024. The RBNZ is also seeing more stickiness in the near-term labour market, with their Q4 unemployment rate assumption revised down 0.2% to 4.2% (ANZ 4.3%). The RBNZ has made a decent revision upwards to their house price assumptions. All these assumptions are on the hawkish side of the ledger. Aside from the near-term outlook for housing, these forecasts are now stronger than ours, implying that if our forecasts eventuate, the RBNZ may get a dovish surprise over the summer.

See page 10 for forecast comparisons against the August MPS and our own forecasts.

Our take

Murphy's Law of Forecasting is alive and well: we take a hike out of our forecasts this month and the RBNZ puts one in. But as we said at the time, while we see the odds of another hike as having fallen below 50%, it had most certainly not fallen to zero, though the market was keen to see it that way. All else equal, today's Statement of course makes a hike more likely, but the data flow will ultimately decide.

The RBNZ was more hawkish than we and certainly the market expected today, but at the end of the day the Committee acknowledged that there are risks in both directions and they will have to stay nimble as the economic picture evolves. While maintaining optionality, what they have achieved is putting a floor under the wholesale yield curve and thereby fixed mortgage rates over the long summer break. As long as the threat of another hike is live, there is a limit to how far the market can rally. And we suspect that was an objective today.

Our forecasts for the big picture are similar to the RBNZ's: the economy is slowing, the export outlook is challenged, unemployment is set to rise, and inflation is cooling. We have been diverging on how quickly domestic inflation will dissipate – we've seen it as being a tougher job than the RBNZ expected, and the RBNZ now appears to be seeing it that way too.

Financial markets

Interest rate and FX markets reacted quickly to today's hawkish Statement, with the bellwether 2yr swap rate jumping about 13bp and the NZD up around half a cent, trading above 0.62 at one point. Given the market mood going into today – with markets priced for a dovish pivot – a hawkish outcome like this was always going to create fireworks, and so it did.

Technically, the RBNZ's track implies a hike in the first half of 2024. That's a long way from where the market is now (markets are still pricing in small odds of a cut by May), and as such, we do see some upside risk to rates. But we wouldn't overplay that theme, mindful of the tendency of markets to front-run the RBNZ, and to swing with the global vibe, which has of late been all about central bank being done and cuts coming in 2024.

To us that speaks to markets spending the summer ebbing and flowing with the data. Some in markets will naturally ask whether this hawkish tilt was entirely tactical, and a push back against dovish market pricing. That may have played a role in MPC deliberations, but when we look at their projections in totality, and consider aspects like the 25bp increase in the Bank's estimate of the neutral OCR, that gives the impression of a central bank that is genuinely worried that the economy might be at risk of getting a second wind too soon, and that's likely to put a floor under interest rates and the NZD.

Monetary policy to remain restrictive

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

Interest rates are restricting spending in the economy and consumer price inflation is declining, as is necessary to meet the Committee's Remit. However, inflation remains too high, and the Committee remains wary of ongoing inflationary pressures.

Internationally, economic growth has been stronger than was expected at the start of this year but remains below trend and is likely to slow further. This subdued growth outlook will continue to restrain New Zealand's export revenues.

In New Zealand, demand growth has eased, but by less than anticipated over the first half of 2023 in part due to strong population growth. The OCR will need to stay restrictive, so demand growth remains subdued, and inflation returns to the 1 to 3 percent target range.

Wage growth has eased from recent peaks. Demand for labour is softening, with job advertisements now below pre-COVID-19 levels. At the same time, strong inward migration is increasing the population and adding to labour supply.

While population growth has eased supply constraints, the effects on aggregate demand are becoming apparent. This is increasing the risk of inflation remaining above target.

The Committee is confident that the current level of the OCR is restricting demand. However, ongoing excess demand and inflationary pressures are of concern, given the elevated level of core inflation. If inflationary pressures were to be stronger than anticipated, the OCR would likely need to increase further.

The Monetary Policy Committee agreed that interest rates will need to remain at a restrictive level for a sustained period of time, so that consumer price inflation returns to target and to support 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. Supply constraints in the economy continue to ease and demand growth is slowing, but to a lesser extent than expected. Inflation remains too high and inflationary pressures continue to emerge. Further slowing in spending growth is needed to reduce demand toward the economy's ability to supply goods and services, to ensure that consumer price inflation returns to its target range.

Global economic growth remains below trend as high interest rates weigh on demand. Easing global demand is placing downward pressure on New Zealand exports, and export revenues are lower than in recent years. However, global prices for some products, such as dairy, have stabilised in recent months. Members noted that to date, global growth has been stronger than was expected at the start of this year, supported by sustained strength in the US economy and a recent lift in economic activity in China. However, going forward, subdued global growth is expected to restrain demand and prices for New Zealand's exports over the medium term.

The Committee discussed international inflation trends. Globally, headline inflation continues to fall, but there are differences in both the timing and magnitude of these declines across countries. Housing rent inflation is an important source of difference in services inflation across countries, with greater upward pressure in economies experiencing high net immigration, such as New Zealand and Australia.

In discussing global financial conditions, the Committee noted that long-term interest rates for government debt have increased, largely in response to the rising volume of public debt. More recently, interest rates have decreased as financial markets anticipate the end of the phase of monetary policy tightening by major central banks. Members also noted that most major central banks have indicated that they intend to retain current restrictive policy rates for longer, and are willing to tighten further, if required.

The Committee discussed recent domestic economic developments. While growth in parts of the economy is slowing, there has been less of a decline in aggregate demand growth than expected earlier in the year. As was noted in the October Review, GDP growth in the second quarter of 2023 was higher than expected while growth in the first quarter was revised up. Consumer spending growth is broadly easing, but some areas of services spending remain more resilient. On an aggregate level, consumption is being supported by the strong growth in population, whereas on a per capita basis, consumption is declining.

Members noted that net immigration has been higher than previously assumed. This has increased the supply of workers into a tight labour market. However, the demand-side effects are becoming apparent. Strong population growth has contributed to an increase in housing rents. Rent increases, and any increases in construction costs in response to greater housing requirements, affect inflation directly, as rental prices and construction costs are accounted for in the consumer price index. Members noted that the outlook for residential investment was currently muted, despite the surge in population growth.

House prices have stabilised after earlier declines, with strong population growth and increased nominal disposable incomes offsetting the effect of higher debt servicing costs. House price increases affect inflationary pressures indirectly, via higher household wealth and an associated increase in consumption. Some members considered that the willingness of households to consume out of wealth may be lower given recent house price falls, higher debt servicing costs, and a softening labour market. Other members considered that there may be upside risks to house prices, and therefore consumption, given the anticipated decline in residential investment.

Annual headline inflation was lower than expected in the September 2023 quarter. This was accounted for by lower inflation for tradable goods and services. Members noted that tradable inflation can be volatile and cannot be relied upon to achieve their inflation target. Non-tradable inflation is easing only gradually and, while all measures of core inflation have declined, they are still elevated. Short-term inflation expectations have declined, and members expect this to continue as headline inflation moves lower. Some members were concerned that 2-year inflation expectations were not declining particularly quickly and that longer-term inflation expectations had also increased. Other members were less concerned as they viewed longer-term inflation expectations as still close to the target midpoint.

In discussing the labour market, members noted that the underutilisation rate and unemployment rate both increased in the September 2023 quarter. Population growth has increased labour supply, as seen in declines in surveyed measures of labour shortages. As economic activity slows, labour demand is also declining, with job advertisements falling to below pre-COVID-19 levels. Wage inflation has eased. Members noted that whilst pressures in the labour market are easing, it is still tight, and employment remains above its maximum sustainable level.

At the time of the October Review, members had noted updates in the Pre-election Economic and Fiscal Update 2023 (PREFU). Specifically, while total government spending as a share of potential GDP is still forecast to decline, this was now by less than previously expected. The PREFU included a material increase in government investment over the medium term, linked to infrastructure requirements.

Members agreed that population growth and government investment would both likely support aggregate supply in the economy. However, they noted that in the short to medium term, demand could only sustainably grow at the economy's production potential without adding to inflationary pressure. The current context is that aggregate demand has been greater than the economy's ability to supply goods and services, creating inflationary pressure. While the economy is moving back into balance, ensuring that demand remains contained will make the task of returning inflation to target much easier.

The Committee noted that the estimate of the long-run nominal neutral OCR has increased by 25 basis points to 2.50 percent within the economic projections, consistent with the Reserve Bank's indicator suite. The long-run nominal neutral rate impacts the central economic projections but has a larger impact in the latter part of the forecast horizon and beyond. Members agreed that the current level of the OCR remains contractionary.

The Committee discussed domestic financial conditions. Credit demand remains subdued as higher interest rates and a slowing economy reduce the ability and willingness of businesses and households to borrow. Mortgage rates have continued to increase, as expected. Members noted that the average rate on outstanding mortgages is expected to increase from 5.4 percent currently to 6.4 percent by mid-2024. The share of disposable income going to debt servicing for households with a mortgage is expected to increase from 15 percent currently to 19 percent.

The Committee discussed the expected evolution of retail interest rates, given ongoing changes in bank funding. Term deposit rates and volumes have increased. Higher term deposit rates are now contributing to ongoing increases in mortgage rates. As competition for term deposits continues, the margin between mortgage rates and wholesale interest rates is expected to return to more historically normal levels. Members agreed this expectation was consistent both with their previous discussions around future changes to retail interest rates, and with assumptions in the economic projection.

The Committee discussed the balance of risks for inflation, output, and employment. Members agreed that while the risk profile remained broadly similar to that discussed at the time of the August Statement, some of the short-term upside risks to activity appear to have eventuated and have therefore been incorporated in the central economic projection. In considering risks, members also specifically discussed two scenarios.

The first scenario was one of persistent domestic demand strength supported by strong population growth, with increases in rents and aggregate consumption feeding into greater inflationary pressure and higher house prices. The second scenario considered a larger global economic slowdown, with growth below trend for longer than currently anticipated. A greater slowdown in global growth would see a fall in the price of imports and further reduce goods export prices and export volumes.

Given the current high level of core inflation, members agreed that there was an asymmetry in the distribution of risks to the outlook for monetary policy across the two scenarios. A global slowdown would likely unwind the additional inflationary pressure that has recently been observed, whereas further domestic demand strength would likely necessitate additional monetary tightening. Some members noted that inflation has now been above target for some time, and that there should be a low tolerance for any increase in the time to return inflation to target.

The Committee noted that the incoming Government's policy programme will have implications for economic activity and inflation. Members agreed that this would be assessed as policies are formally incorporated into the Treasury's official forecasts.

The Committee discussed the backdrop of heightened geopolitical tension and risk of spillovers to the global economy. Members noted that whilst they remain attentive to global developments, they will respond to shocks if and when they eventuate. The Committee also discussed the outlook for China and noted that while economic data over recent months have improved, structural challenges facing the Chinese economy remain concerning for long-term growth prospects. Potential growth is slowing, partly due to demographic trends, but also due to substantial declines in productivity growth. High levels of debt, particularly in the property sector, and weak demand remain the most acute downside risks.

Members were cognisant of the likelihood of an El Niño climate pattern in coming months. They noted that the scale of potential impact is highly uncertain and depends on the timing and location of any droughts. There may be differentiated impacts for different agricultural commodities. No specific drought impacts have been incorporated in the economic projection and members agreed they would continue to closely monitor the evolution of El Niño over coming months.

The Committee agreed that in the current circumstances, there is no material trade-off between meeting their inflation and employment objectives and maintaining stability of the financial system. Members noted that slowing economic activity is not being experienced evenly across the economy. The commercial property and agricultural sectors are starting to experience challenges and may be vulnerable. For highly-indebted households, pockets of stress are likely to grow as debt servicing burdens increase.

In discussing their Remit objectives, the Committee noted inflation is still expected to decline to within the target band by the second half of 2024. Pressure in the labour market is easing, although employment remains above its maximum sustainable level. Members agreed that monetary policy was supportive of sustainable house prices.

In discussing the appropriate stance of monetary policy, members agreed they remain confident that monetary policy is restricting demand. Nevertheless, ongoing excess demand and inflationary pressures were of concern, given high core inflation. Members discussed the possibility of the need for increases to the OCR. Members agreed that with interest rates already restrictive, it was appropriate to wait for further data and information to observe the speed and extent of easing in capacity pressures in the economy.

The Committee agreed that interest rates will need to remain at a restrictive level for longer, to ensure annual consumer price inflation returns to the 1 to 3 percent target range and to support maximum sustainable employment. On Wednesday 29 November, the Committee reached a consensus to maintain the Official Cash Rate at 5.50 percent.

Attendees

Reserve Bank members of MPC: Adrian Orr, Christian Hawkesby, Karen Silk, Paul Conway

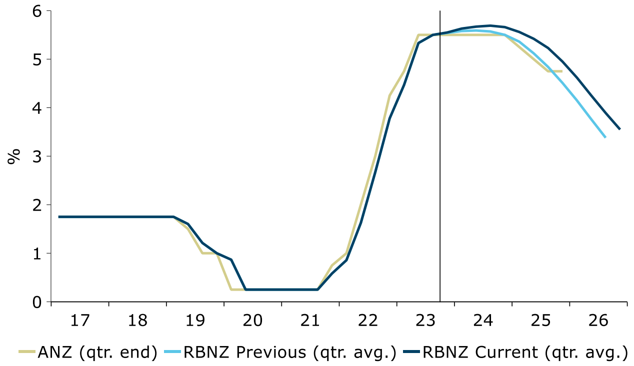
External MPC members: Bob Buckle, Peter Harris, Caroline Saunders

Treasury Observer: Dominick Stephens

MPC Secretary: Kate Poskitt

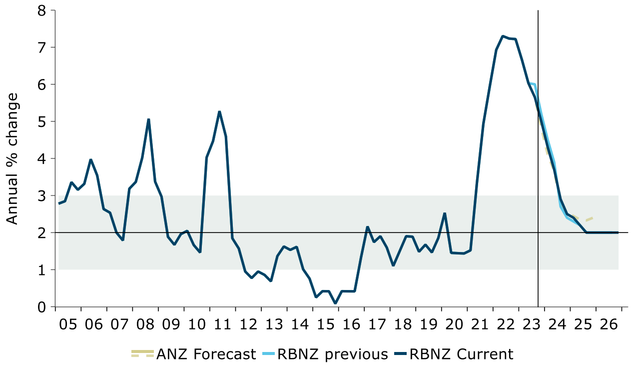
Key forecasts: more hawkish all round

The RBNZ lifted its peak OCR by 10bp…



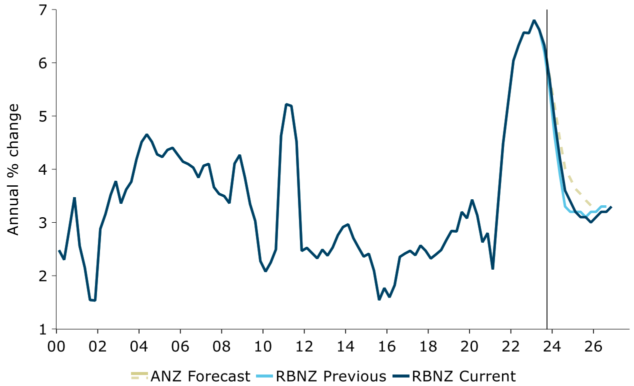
Source: RBNZ, Macrobond, ANZ Research

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

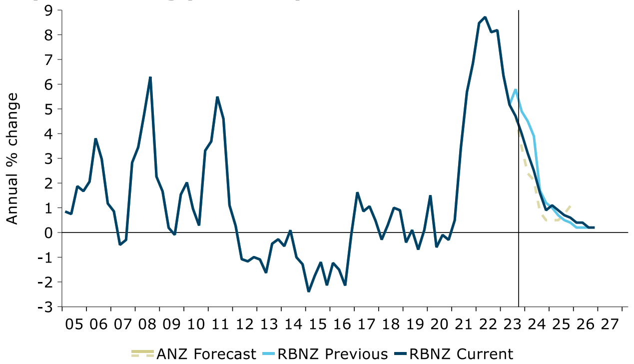


Source: RBNZ, Stats NZ, Macrobond, ANZ Research

…with non-tradables a little higher…

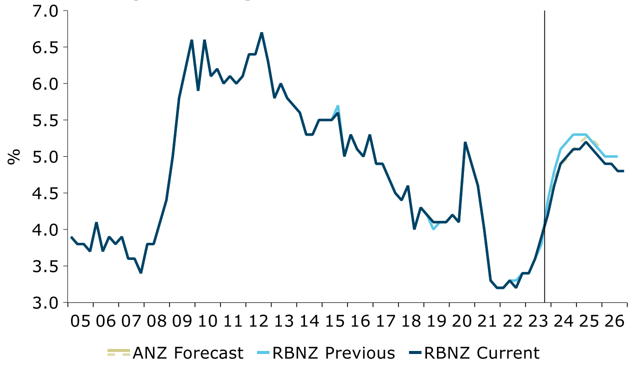


…while the tradables outlook is dominated by a helpful starting point surprise



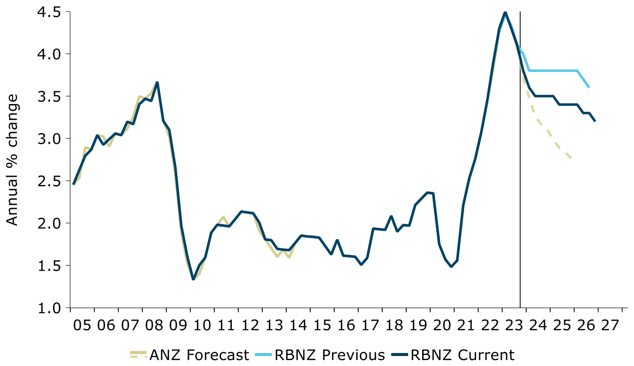
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

The unemployment rate peaks at 5.2%, 0.1%pts lower than previously



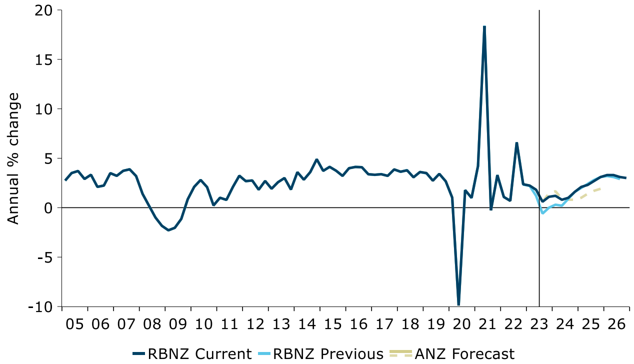
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

LCI wage growth looks more sensible



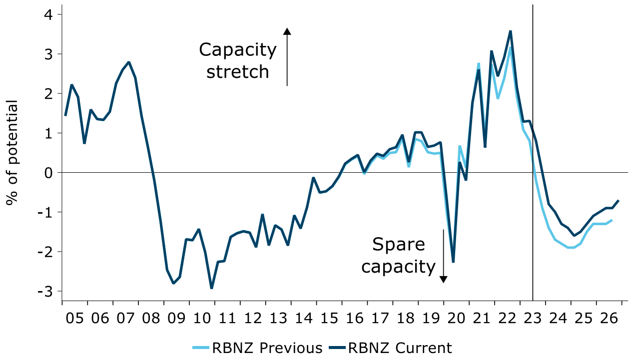
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

GDP forecasts have been revised up, closer to ours…



Source: Stats NZ, Macrobond, ANZ Research

…with the past estimates and outlook for spare capacity (output gap) revised up



Source: RBNZ, Macrobond, ANZ Research

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