ANZ Research

RBNZ Monetary Policy Statement Review

28 February 2024

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Contact

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Pivot!

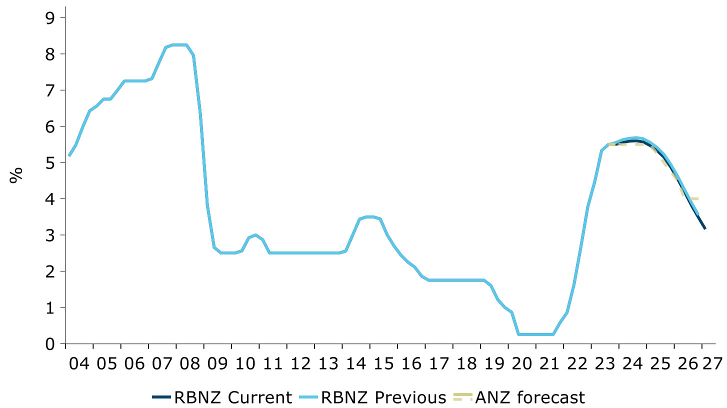
Summary

- The RBNZ today left the Official Cash Rate (OCR) unchanged at 5.5% and reduced the forecast peak OCR from 5.69% to 5.6%.
- We got this one totally wrong. We had expected the RBNZ would hike the OCR today, or failing that, up the ante on hikes with a higher forecast peak in the OCR. However, the RBNZ put a lot of weight on the downside surprise in Q3 GDP, revising down their estimate of how stretched (and thus inflationary) the economy is despite what's been a surprisingly mixed bag of capacity indicators. That plus the lower starting point for tradable inflation offset the upward surprises in other areas, such as the higher starting point for non-tradable inflation and lower unemployment.
- Both interest rates and the NZD fell following the decision. The market is now pricing in essentially no chance of hikes, with one cut by August and another by November.
- For our part, we continue to think there's a high chance that the data will demonstrate that 5.5% is not sufficiently high to return inflation to target in an acceptable time frame. However, the evidence threshold for the RBNZ committee is clearly much higher than we appreciated, so we have reluctantly parked further hikes back in the risk basket, pushing cuts out to mid-2025 (and slowing them) as the trade-off for not acting proactively now is that rates are required to be high for longer to do the job.

In brief

As widely expected, albeit not by us, the RBNZ today left the Official Cash Rate (OCR) unchanged at 5.5%. The peak forecast OCR was lowered by 9bps to 5.60%. In addition, the comment that the OCR will "likely" need to go higher in the case of additional demand was dropped. Yields fell sharply, with the market no longer pricing any chance of a hike this year, but rather two cuts.

Figure 1. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

Key quotes:

- **OCR outlook:** "The Committee agreed that interest rates need to remain at a restrictive level for a sustained period of time, to ensure annual consumer price inflation returns to the 1 to 3 percent target range."
- **Policy transmission:** "Members discussed the lags of monetary policy and how the economy has evolved relative to the series of projections made over the last year or so. In general, the economy has evolved as expected."
- **Labour market:** "Labour markets have evolved as expected, and a further moderation in labour market capacity pressure is expected. Capacity pressures in the labour market will need to continue to ease to meet our inflation mandate."
- **Domestic activity:** "Recent developments in economic indicators have been mixed but point to subdued growth in the near term."
- **Inflation outlook:**
  - "Members noted that overall, risks to the outlook for inflation were more balanced than at the time of the November 2023 Statement."
  - "The Committee noted, given current projections, there was limited tolerance to increase the time to the target mid-point."
  - "Easing capacity pressures and declining inflation expectations are expected to reduce non-tradables inflation, albeit at a slightly slower pace than assumed in the November Statement. This is slightly more than offset by a much lower starting point and weaker outlook for tradables inflation, reflecting declining global prices for our imports."
- **Capacity pressures:**
  - "The Committee noted that aggregate demand is now better matched with the supply capacity of the economy."
  - "The current assessment of capacity pressures is consistent with previous projections. These past forecasts and outcomes are consistent with the assessment that monetary policy settings have constrained demand broadly as expected."
- **Wage growth:**
  - Committee (Summary Record of Meeting): "The unemployment rate is lower than projected, but wage inflation has been more subdued."
  - MPS (analysts): "Strong growth in wages was seen across several industry groups, suggesting wage growth is slightly stronger and more broad-based than expected."

The overall tone of the above quotes was not nearly as hawkish as we had anticipated, with the surprisingly weak Q3 GDP data (and possibly the weak Q4 real retail sales data, though it arrived late in the piece) persuading the Committee that core inflation will soon start to fall more quickly. The RBNZ remains in data-watch mode, as is entirely appropriate given the uncertainty prevailing. But for now, 'on hold' remains the firm position.

As always, the RBNZ outlined risks to the outlook on both sides. Surprisingly, the Summary Record of Meeting noted that "members noted that overall, risks to the outlook for inflation were more balanced than at the time of the

November 2023 Statement.” This sticks out like a sore thumb to us, as we’re seeing in our business survey and in the non-tradables inflation that sticky inflation risks have intensified.

RBNZ forecasts in brief

Looking through data revisions, the RBNZ’s activity forecasts (see charts on page 10) tell much the same story as those published in November, but with a slightly weaker vibe in the near term. Household consumption is expected to be a little weaker; exports too. Come 2025, the RBNZ’s growth forecasts are little changed from November, which isn’t surprising: medium-term forecasts can quite reasonably be interpreted as the RBNZ’s best estimate of what needs to happen to get inflation back to target, and that hasn’t changed meaningfully.

But the starting point matters in terms of having a big say in what OCR settings are seen as required to get to that medium-term picture. The weak Q3 GDP result has seen the RBNZ revise down its estimate of the starting-point output gap despite a decidedly mixed bag of direct capacity indicators over the last three months.

The RBNZ’s CPI inflation forecasts are little changed from November, with a stronger starting point for non-tradables baked in and weak tradables broadly offsetting. Headline inflation is forecast to reach 2% by Q4 2025, one quarter later than the November MPS, so clearly there was some tolerance for a slower return of inflation to target after all.

See page 10 for forecast comparisons against the November MPS and our own forecasts. As the charts show, we expect inflation to fall more slowly than the RBNZ does over coming months (with today’s easing in monetary conditions increasing that risk).

Our take

Well. We couldn’t have gotten that one more wrong. We were obviously surprised by not just the OCR decision today (which was a line ball call) but particularly by the RBNZ’s assessment that inflation risks have become less pronounced since November.

We got this one wrong on two main fronts. First, we took the November MPS at face value as suggesting that the threshold for a further hike was low, whereas it appears there may indeed have been a bigger element of ‘talking tough’ to support rate expectations and thus mortgage rates over the summer. Second, we estimated that the surprisingly mixed indicators for the state of spare capacity in the economy would offset the negative starting point surprise inherent in the weak Q3 GDP result, but it appears that the latter dominated. Indeed, they discounted the former, saying the labour market was evolving “as expected”.

It also, to our surprise, appears that the lower headline inflation starting point, even though driven by the tradable side, has made a meaningful difference in how relaxed (or not) the RBNZ is about the outlook for home-grown inflation. There was a lot less discussion of non-tradable inflation than in the November Statement, and the RBNZ commented that the helpful downward surprise on tradable inflation “more than offset” an expected slower decline in non-tradable inflation in terms of their medium-term CPI forecasts. The RBNZ has made many comments in the past about how tradable inflation cannot be relied upon to bring inflation sustainably back to target, so this take took us by surprise.

Of course, the RBNZ has its view, and we have ours, and our basic economic view is unchanged: with the OCR where it is, we think there's a good chance inflation is not going to return to target in an acceptable time frame. It looks to us like too-high inflation is making itself at home.

The OCR track, which peaks 9bp above the current level of 5.5%, indicates that the RBNZ still sees some upside risk overall. However, the evidence threshold for more hiking being required is clearly *much* higher than we took from the tone and OCR forecast of the November MPS. We still think there is a very strong chance that the next move in the OCR is up rather than down. The focus on headline rather than non-tradable inflation is risky in our view, given domestic inflation is looking very persistent. But in the MPS today, the RBNZ has made it clear that they are going to take quite some persuading that more hikes are required. Therefore, although our view of the job facing the RBNZ hasn't changed, we have reluctantly parked our call for a higher OCR back in the risk basket, and instead pushed out cuts to mid-2025.

We would point out that insofar as the MPS today has eased monetary conditions significantly, today's pivot increases the probability that hikes are required, all else equal. But we acknowledge that all else is never equal, and both we and the RBNZ will undoubtedly continue to be surprised by the economic story as it unfolds. We will be watching the data just as closely as the RBNZ. Next stop, Q4 GDP on 21 March, then the April Monetary Policy Review, followed by Q1 CPI. May brings the Budget, and a much clearer picture of the likely net stance of fiscal policy from an inflation-fighting point of view – though a little awkwardly, the MPS is 8 days before the Budget (30 May).

Financial markets

Markets weren't expecting a hike today, but there was a widespread expectation that the RBNZ would at least retain a hawkish tone and not lower the OCR track. But that's not what we have seen. Financial markets view the lower track (which has a lower peak and a 3.16% endpoint in Q1 2027) as a "dovish pivot", and we have seen interest rates fall sharply across the yield curve. Within half an hour of the announcement, the 2yr swap rate had fallen around 20bps to 5.01%, and markets were pricing in two OCR cuts by November.

Given the shock of the announcement and the way US markets reacted to the Federal Reserve's dovish pivot in December we wouldn't be surprised to see rates fall further in coming days, with the short end leading the way, steepening the curve. Moves seen in FX markets were just as brutal, with NZD/USD gapping around 50bps lower instantaneously, and NZD/AUD down around 60bps. Given the support higher interest rates have provided the NZD over recent weeks, these moves also have scope to extend if the move to lower interest rates gathers momentum.

Monetary policy remains restrictive

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

Over the past year or so, the New Zealand economy has evolved broadly as anticipated by the Committee. Core inflation and most measures of inflation expectations have declined, and the risks to the inflation outlook have become more balanced. However, headline inflation remains above the 1 to 3 percent target band, limiting the Committee's ability to tolerate upside inflation surprises.

Restrictive monetary policy and lower global growth have contributed to aggregate demand slowing to better match the supply capacity of the New Zealand economy. With high immigration and weaker demand growth, capacity constraints in the New Zealand labour market have eased.

However, recent high population growth is supporting aggregate spending, as evident in upward pressure on dwelling rents, for example.

Internationally, global economic growth remains below trend and is expected to slow further during 2024. This subdued environment will support a further moderation in New Zealand's import price inflation.

The outlook for the China economy remains particularly weak relative to recent historical norms, with structural factors constraining long-term growth. A more general risk to global growth is that central banks may need to keep policy interest rates at restrictive levels for longer than currently reflected by financial market pricing, to ensure that inflation targets are met.

Heightened geopolitical and climate conditions remain a risk for inflation. The recent rise in global shipping costs is one manifestation of these risks. The Committee remains alert to these relative cost pressures and will act to limit spillovers into general inflation if necessary.

The Committee remains confident that the current level of the OCR is restricting demand. However, a sustained decline in capacity pressures in the New Zealand economy is required to ensure that headline inflation returns to the 1 to 3 percent target. The OCR needs to remain at a restrictive level for a sustained period of time to ensure this occurs.

Summary record of meeting

The Monetary Policy Committee discussed recent developments in the New Zealand and global economies. The Committee agreed that the New Zealand economy has evolved largely as expected over the past year or so. Headline inflation, core inflation and most measures of inflation expectations are continuing to decline. However, inflation remains above the Committee's target range. Restrictive monetary policy is contributing to an easing in capacity pressures. Monetary policy needs to remain restrictive to ensure that inflation returns to target.

Global growth was below trend last year. New Zealand's trading partner growth is expected to slow in 2024. This will support a further drop in global inflation and New Zealand import price inflation. Measures of headline and core inflation continue to fall among our trading partners. Global supply disruptions have eased, and restrictive monetary conditions continue to contribute to reduced demand. Although prices of New Zealand's exports have recently increased, continued below trend global growth is expected to limit the scale of further increases.

In discussing global financial conditions, the Committee noted that long-term wholesale interest rates have fallen since the November Statement. This has put downward pressure on domestic wholesale interest rates. Globally, central banks have generally kept policy interest rates steady at restrictive levels, and financial market participants have shifted their focus towards the timing and degree of potential policy rate cuts expected this year.

The Committee discussed recent domestic economic developments. Capacity pressures have eased significantly over the past year. Aggregate demand is now better matched with the supply capacity of the economy. A combination of lower demand and growing supply is bringing domestic inflation down. Below-trend global growth and slightly lower prices for our imported goods and services have also helped to lower headline inflation over recent quarters.

Members noted that gross domestic product (GDP) declined by 0.3 percent in the September 2023 quarter. This was weaker than projected in the November Statement. Revisions to GDP going back several years imply that potential GDP – the amount of production that the economy can supply sustainably – has also been lower than previously assumed. On net, these factors imply that the starting point for capacity pressures in the New Zealand economy is only slightly lower than previously assumed.

The Committee discussed the low rate of productivity growth implied by recent GDP data. If sustained, lower productivity would contribute to a lower rate of potential growth of the economy. This would limit the rate at which the economy can sustainably grow without generating inflation.

Members noted that strong net immigration is contributing to demand, with the recent increase in rent inflation an example. However, net immigration also means that there are more workers available, boosting the supply capacity of the economy. Businesses are reporting that it has become much easier to find workers. In general, capacity pressures in the labour market have eased.

Members discussed the recent increases in global dairy prices and lower prices for our imported goods and services. These developments have resulted in an improvement in New Zealand's terms of trade, which will increase primary sector incomes and domestic activity. Recent attacks on shipping in the Red Sea and drought near the Panama Canal are creating delays in getting exports to global markets and increasing global shipping costs. These rising costs could decrease exporter profitability and will likely feed into global and imported inflation if sustained.

Members noted that annual house price inflation remains modest. There is heightened uncertainty around the outlook for house prices. This reflects continued restrictive interest rates, the scale of decline in residential investment, and the net economic effects of currently strong net immigration.

The Committee discussed recent inflation outturns. Annual consumer price index (CPI) inflation declined to 4.7 percent in the December 2023 quarter. While this is much lower than its peak of 7.3 percent in mid-2022, it remains above the Committee's 1 to 3 percent target band. Inflation was lower than expected in the December 2023 quarter. Both tradable and non-tradables inflation fell, with tradables inflation falling by more than expected. Recent drops in core inflation and business inflation expectations are encouraging, but they remain above the 2 percent mid-point of the Committee's target band.

Members discussed the lags of monetary policy and how the economy has evolved relative to the series of projections made over the last year or so. In general, the economy has evolved as expected. Headline inflation is slightly lower than had been assumed, reflecting lower-than-expected tradables inflation. The unemployment rate is lower than projected, but wage inflation has been more subdued. The current assessment of capacity pressures is consistent with previous projections. These past forecasts and outcomes are consistent with the assessment that monetary policy settings have constrained demand broadly as expected.

The Committee discussed the implications of fiscal policy for the economic outlook and the potential impacts of new proposed policies. The Committee noted that the central projection for government spending is based on Treasury's published forecasts in the Half Year Economic and Fiscal Update (HYEFU) 2023. Government expenditure is projected to decline as a share of the economy in coming years. There is uncertainty over the timing and scale of new fiscal policy initiatives and the implications for monetary policy. The Committee will take any new fiscal initiatives into account when Budget 2024 is released in May.

The Committee discussed the recent publication of the Selected Price Indices from Stats NZ. The Committee welcomed the publication of these monthly indicators. The Committee also noted that more frequent publication of inflation figures and more regular reweighting of the CPI would be consistent with global practice. Such changes would support the Committee in assessing the current state of the economy, particularly in periods of heightened economic uncertainty and volatility.

Members discussed recent developments in domestic financial conditions. Overall, credit growth remains subdued. Financial conditions have become less restrictive since the November Statement. Mortgage rates have dipped slightly at most tenors and term deposit rates have fallen at tenors of more than six months. The margin between mortgage rates and wholesale interest rates is expected to return to more historically normal levels, as competition for term deposits continues and funding conditions for banks continue to tighten. This is expected to see mortgage rates hold up relative to wholesale interest rates.

The Committee discussed the key risks to the outlook for inflation. Members noted that overall, risks to the outlook for inflation were more balanced than at the time of the November 2023 Statement. However, from a monetary policy perspective, there remains less capacity to absorb upside inflation surprises, relative to downside surprises.

The Committee discussed the outlook for China, given its significance for the global economy and for New Zealand export and import prices. Structural challenges facing the economy in China remain concerning for long-term growth. 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.

The Committee discussed the backdrop of heightened geopolitical tension and risk of spillovers to the global economy. The current rise in global shipping costs is a realisation of these spillovers. Although higher shipping costs add to near-term inflation, projections assume that this relative price shock will reverse. There is considerable uncertainty over the size and duration of higher shipping costs. Consistent with the Remit, the Committee has therefore 'looked through' the first-round effect of recent higher shipping costs. Nevertheless, the Committee remains alert to these costs lasting longer than currently assumed. In that event, potential spillovers into general prices might require a monetary policy response.

Members also noted downside risks to the global growth outlook in advanced economies. Median analyst projections were for a steady decline in inflation, with global growth expected to track modestly below the growth rates seen in 2023. A more general risk to global growth is that central banks may need to keep policy interest rates at restrictive levels for longer than currently reflected in financial market pricing, to ensure that inflation targets are met.

Members noted that, while pressures in the New Zealand labour market are easing, some of the labour market capacity measures in our suite have eased only modestly. The Committee noted that variations in labour demand lag broader economic activity. Labour markets have evolved as expected, and a further moderation in labour market capacity pressure is expected. Capacity pressures in the labour market will need to continue to ease to meet our inflation mandate.

The Committee agreed that in the current circumstances, there is no material trade-off between meeting their inflation objectives and maintaining the stability of the financial system. The Committee discussed the Bank's current public consultation on the proposed settings for Debt-to-Income (DTI) restrictions on borrowing. The Committee agreed that the DTI policy will further support financial stability through the interest rate cycle.

The Committee noted the recent changes to the Reserve Bank Act, Remit and MPC Charter. In line with the Charter, the Committee discussed the reasons inflation is outside of the target range, the expected time for inflation to return to the target midpoint of 2 percent, and the reasons for that timeframe.

The Committee noted that high inflation reflected:

- the significant disruption to global supply stemming from COVID-related responses from policy makers, businesses, and households.
- the substantial disruption to domestic production from COVID-related policies and a tight domestic labour market,
- the impact on demand of the easing in monetary policy and rise in fiscal spending undertaken at the beginning of the pandemic in the face of substantial uncertainty and significant downside risks to the economy, and,
- the increase in commodity prices and shipping costs resulting from war and geopolitical tension.

These factors are discussed in detail in the November 2022 Review and Assessment of the Formulation and Implementation of Monetary Policy.

The Committee noted that annual headline CPI inflation was expected to return to the target band in the September quarter this year and that monetary policy settings are consistent with annual headline CPI inflation returning to the 2 percent target midpoint later in 2025. The Committee noted, given current projections, there was limited tolerance to increase the time to the target mid-point. The Committee is conscious that the economy has limited capacity to absorb further upside inflation surprises, as this could risk a rise in inflation expectations and make it more difficult to get inflation back to target.

The Committee noted that aggregate demand is now better matched with the supply capacity of the economy. Policy settings consistent with the projected time for CPI inflation to return to the 2 percent target midpoint result in a period of excess supply. These ongoing restrictive monetary policy settings are necessary to guard against the risk of a rise in inflation expectations, while avoiding unnecessary instability in output, employment, interest rates and the exchange rate.

In discussing the appropriate stance of monetary policy, members agreed they remain confident that monetary policy is restricting demand. A further decline in capacity pressure is expected, supporting a continued decline in inflation. The Committee agreed that interest rates need to remain at a restrictive level for a sustained period of time, to ensure annual consumer price inflation returns to the 1 to 3 percent target range. On Wednesday 28 February, the Committee reached a consensus to keep the Official Cash Rate at 5.50 percent.

Attendees

MPC members: Adrian Orr (Chair), Bob Buckle, Caroline Saunders, Christian Hawkesby, Karen Silk, Paul Conway, Peter Harris

Treasury Observer: Dominick Stephens.

MPC Secretary: Adam Richardson.

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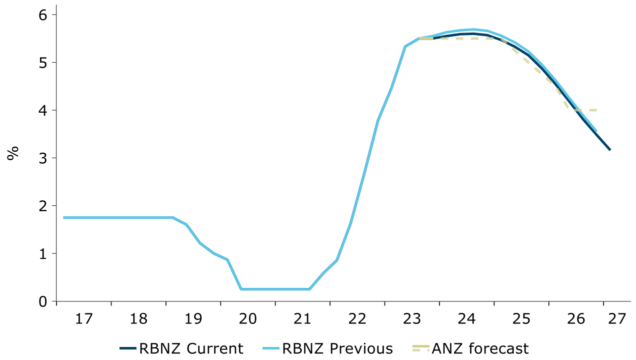
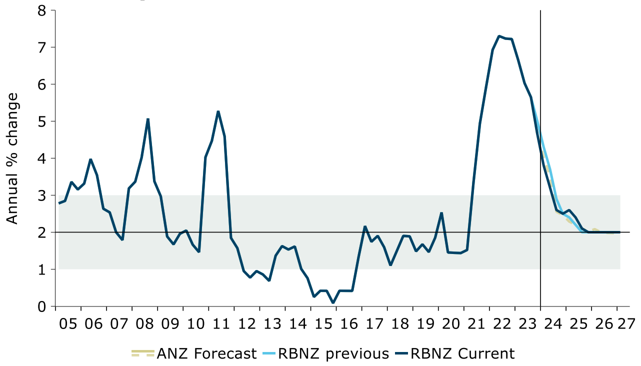
Key forecasts: lower peak to achieve much the same result

The RBNZ lowered its peak OCR 9bps to 5.60%



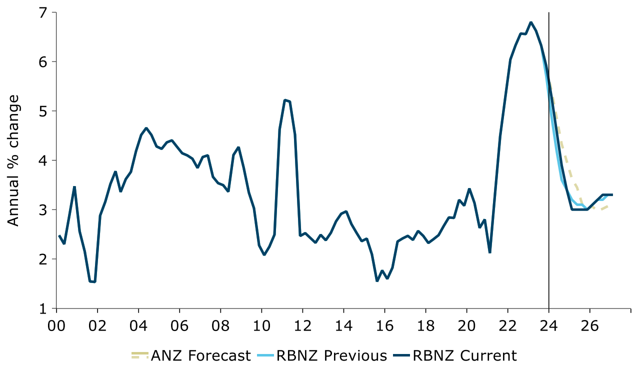
Source: RBNZ, Macrobond, ANZ Research

...with a very similar CPI inflation outlook...



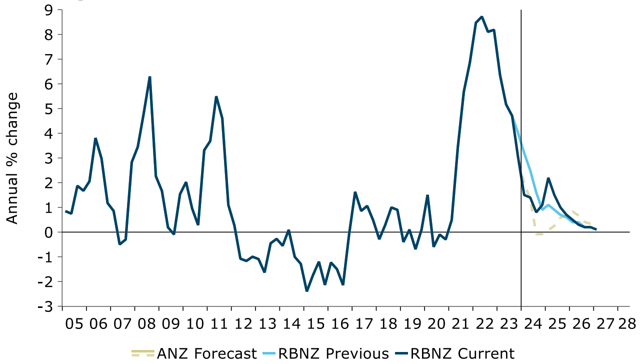
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

...with non-tradables similar overall...



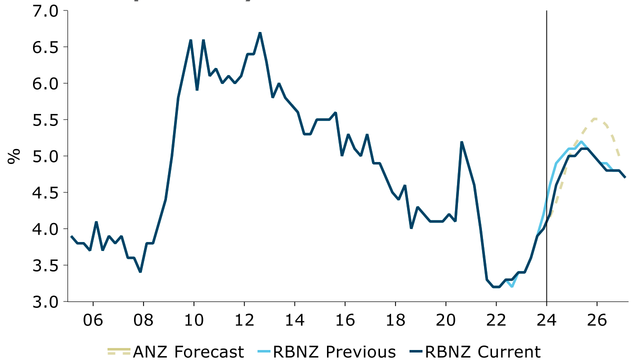
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

...while the tradables outlook is dominated by a weaker starting point surprise, then a bump (base effect?)



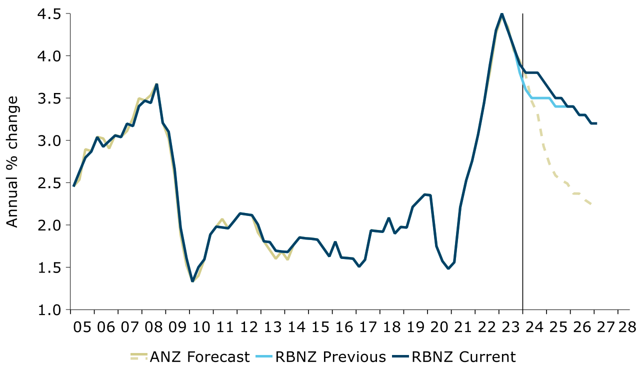
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

The unemployment rate peaks at 5.1%, 0.1%pts lower than previously



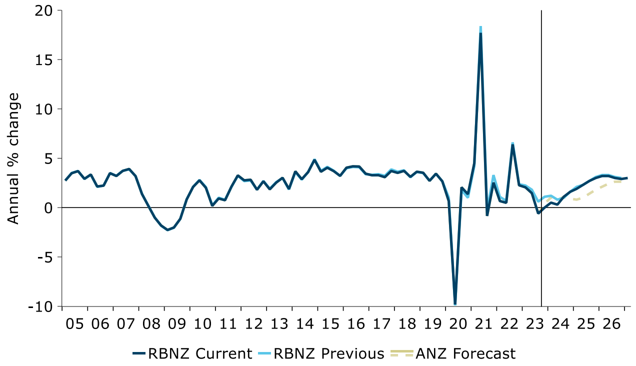
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

LCI wage growth forecast to slow only gradually



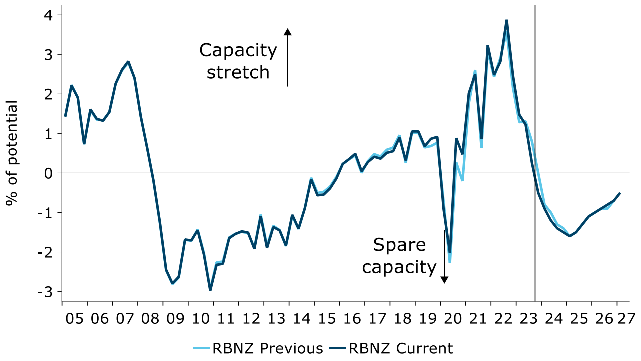
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

Near term GDP forecasts are softer...



Source: Stats NZ, Macrobond, ANZ Research

...with the near-term outlook for spare capacity (output gap) revised slightly lower



Source: RBNZ, Macrobond, ANZ Research

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