ANZ Research

NZ Insight: Risks to the OCR outlook

30 November 2022

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How much is too much?

Introduction

The Reserve Bank of New Zealand (RBNZ) startled all comers with its hawkishness last week. We had already been discussing upside risk to our forecast OCR peak of 5%, and as a result of confirmation that the RBNZ is willing to not only risk but actually deliberately engineer a recession in order bring down inflation, we have now upgraded our OCR forecast to a peak of 5.75%, comprising another 75bp lift in February, and then a tapering off as evidence mounts that the economy is indeed cooling markedly, with a 50bp hike in April and a final 25bp hike in May.

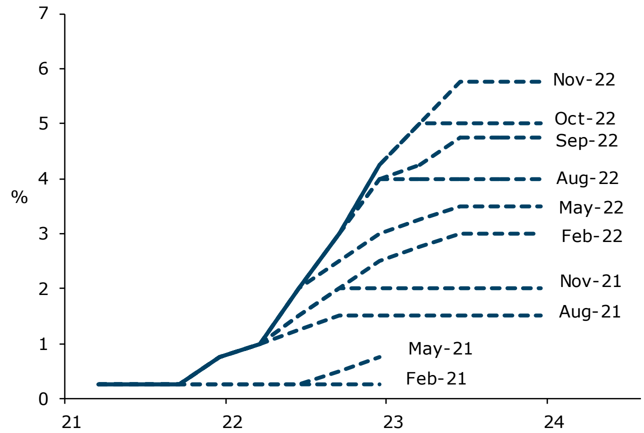
That final 25bp hike is a hat tip to how we see the risks tilted around the RBNZ's updated forecasts – but if anyone wasn't sure that economists can't in fact see six months into the future with any accuracy, the last few years should have clarified that point. Particularly in this environment that is so far out of recent experience, no one should talk in definitive terms about their forecasts being 'right' or even 'highly likely'. But that doesn't mean it isn't a useful exercise to think methodically about the range of possible outcomes, and which risks and data we should be monitoring closely.

Figure 1 shows how our OCR forecasts have evolved over the past couple of years. Of course it's not just us; everyone has been on the same journey of repeatedly upgrading forecasts for inflation, including the sticky non-tradable bit of it (see the RBNZ's forecast efforts, figure 2).

Inflation pressures have surprised endlessly on the upside in the past year – not just inflation itself, but also the resilience of consumer spending, the strength of the labour market, and wage growth.

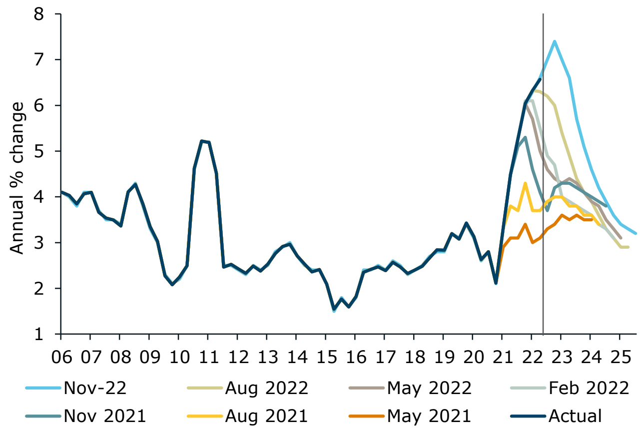
Looking at the charts below, it doesn't appear to be a fair fight in terms of the most likely direction of the next revision to our forecasts from here. But last week's Monetary Policy Statement did feel different. The RBNZ leapfrogged everyone with their hawkishness, and the upward revision to their non-tradable inflation forecast was startling, particularly in light of it being a genuine forecast revision, as opposed to primarily a starting point surprise, quickly unwound.

Figure 1. ANZ OCR forecasts



Source: RBNZ, ANZ Research

Figure 2. RBNZ non-tradable inflation forecast



Source: Stats NZ, RBNZ, ANZ Research

The hurdle for more upward surprises versus RBNZ forecasts is therefore considerably higher now. Not insurmountable, by any means – high inflation is more volatile and unpredictable, and front-footing inflation risks in the last year or so hasn't tended to result in staying ahead of the data for long! But the risks around our updated 5.75% OCR peak feel very much two-sided, whereas last year was a one-way ticket higher.

So in that context, let's take a look at what, over the next six months, could cause the OCR hikes to stop short of 5.75%, versus what could cause more of the same, ie upward revisions to what's needed to tame the inflation beast. And finally, what risks, if they materialised, would likely be too late to prevent the OCR peaking at these levels but might signal that the RBNZ has over-achieved and may need to ease up?

1. Risks to the upside

Inflation expectations

The RBNZ doesn't forecast inflation expectations, but they are more crucial than ever. The RBNZ now explicitly incorporates short- and medium-term measures into their estimates of the nominal neutral OCR, which is used to gauge how stimulatory or contractionary the current stance of policy is. And their conclusion as of last week was that most likely they've in actuality just been easing off the accelerator all this time, and only now, with this most recent hike, can they be (reasonably) confident that they've hit the brake.

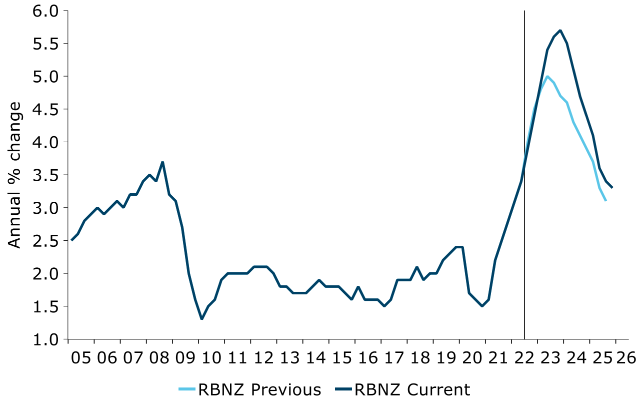
That explains the urgency; the RBNZ has concluded that it has a lot more work to do. Of course it's not all a sudden realisation – it's been clear for some time that the economy (consumer spending in particular) is not cooling as rapidly as expected. But this new framework elevates the importance of inflation expectations.

One can certainly debate whether it's wise to put much weight on shorter-run expectations, which tend to be pretty backward-looking and not have much predictive power. It effectively ups the weight on past inflation outcomes when making OCR decisions, which, all else equal, ups the odds of oversteering. But in this environment, where self-reinforcing feedback loops appear to be emerging, the RBNZ is taking no chances. So inflation expectations are a must-watch. They rose in the ANZ Consumer Confidence survey this week, breaking a downward trend, and they hit a record high in the ANZ Business Outlook. Not a great start.

Wages

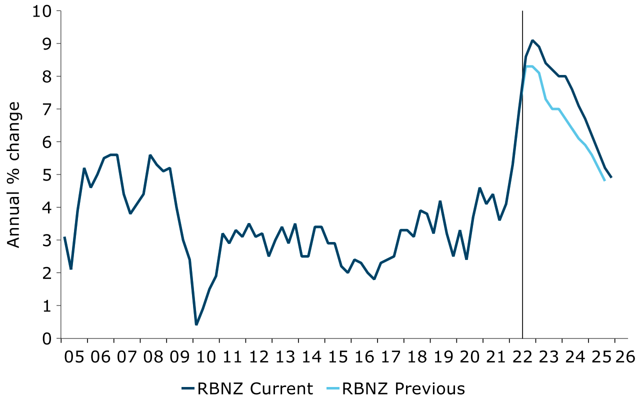
The RBNZ has revised up its wage forecasts considerably (figures 3 and 4) (see page 33 of the Monetary Policy Statement for a useful discussion of what the different measures of wages are intended to capture).

Figure 3. LCI wage forecasts



Source: RBNZ, Stats NZ, Macrobond, ANZ Research

Figure 4. QES wage forecasts



Source: RBNZ, Stats NZ, Macrobond, ANZ Research

Essentially, the forecasts build in stronger feedback loops between persistently high headline inflation (now expected to remain above 7% for a full year) and wage demands – and wage outcomes, in a tight labour market. With such large upward revisions, the hurdle for an upward surprise to wages has risen, just as it has for CPI inflation. But we wouldn't rule it out, given the momentum evident, and recent large settlements.

We've added questions to the ANZ Business Outlook survey asking firms for numerical estimates of past and expected wage settlements. The data is too new to be able to use it formally for forecasting, but it's worth keeping an eye on for a hint as to when the turning point might come.

The higher wage growth goes, the better households in aggregate can handle mortgage rate increases, and so the higher the OCR has to go, all else equal, to get the desired traction on consumer spending.

Unemployment

The RBNZ is forecasting the unemployment rate to start to rise quite sharply from Q1 next year. One key unknown here is how much unmet labour demand needs to be eviscerated before lower employment intentions start to actually cut into the meat of employment. In our view, the risk is tilted towards it taking a bit longer for the unemployment rate to start to rise; in our forecasts the lift starts in Q2 2023. At that point (the last data available before the RBNZ stops hiking in our forecasts), we are anticipating the unemployment rate to be 3.5%, whereas the RBNZ is expecting 3.9%.

In terms of what to keep an eye on, in addition to employment intentions in the ANZ Business Outlook survey, there's a whole swathe of monthly employment data, including job ads. Some of it has been known to point in opposite directions, to be fair, but we'll be perusing all of it closely.

One additional upside risk to the RBNZ's estimates of inflation pressures coming out of the labour market lurks in the detail of the RBNZ's forecasts. The sharp rise in unemployment the RBNZ is forecasting is partly predicated on the labour force participation rate holding up at current record highs in the face of the labour market weakening. That's not unprecedented, but it would be unusual (figure 5). If the participation rate were to actually fall as employment growth does (as workers become discouraged about their prospects of finding suitable work), then the unemployment rate would rise by less, all else equal. Firms would have to work harder (and pay up more) to find staff than otherwise.

Figure 5. RBNZ unemployment and participation rate forecasts

Source: Stats NZ, RBNZ, Macrobond, ANZ Research

Global inflation

It would be a push to say there are many central banks who are looking on top of inflation at this point. Imported inflation could stay higher for longer than expected; the oil price could jump on geopolitical events; the NZD could tank again. Any of these things could boost imported inflation in an unhelpful way.

2. Downside risks to OCR hikes

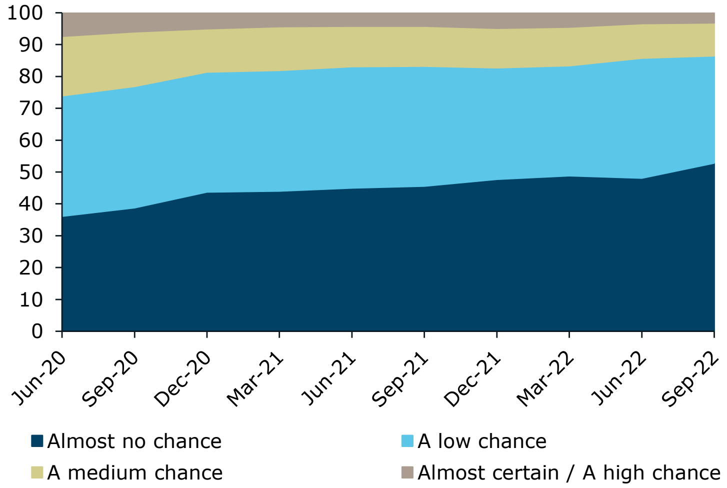
So far, those risks are largely a case of 'more of the same'. But the risks on the other side are definitely growing. Let's take a look at reasons why OCR hikes could be slower than we currently anticipate, or indeed not delivered at all.

Policy lags versus shock value

Almost 60% of mortgage debt is still on a mortgage rate of less than 4%, and roughly half of mortgage debt is due to re-price in the next 12 months. For some households, the shock to their remaining spending power will be considerable. It'll be less than it would have been if wages hadn't been growing fast, but it's still going to hurt. Naturally, the higher your debt to income (DTI) ratio, the less offset income growth will provide to the impact of higher rates.

In theory, households should be anticipating higher debt-servicing costs when their mortgages roll over, and reducing spending now. But it hasn't been happening to a large extent, perhaps because very strong job security has meant the precautionary savings motive hasn't been triggered in a big way. More than half of respondents in the latest Household Labour Force Survey reported that they thought there was "almost no chance" of losing their job (figure 6).

Figure 6. HLFS employment confidence



Source: Stats NZ, ANZ Research

But the RBNZ went for shock value last week, with the Governor making a direct appeal to consumers to "cool the jets" and rein in their spending, and forecasting a headline-grabbing recession and a sharp rise in unemployment. The next few months will demonstrate whether there will be a step-change in demand in response to the RBNZ's announcement last week. It certainly generated by far the most media interest of any OCR decision in a long time, which was arguably exactly the RBNZ's intention.

The upshot: while monetary policy works with long and variable lags, there is currently potential for some rather more abrupt changes in households' (and thereby firms') risk-taking behaviour – big-ticket spending, employment and investment – that might see things cool more quickly than anticipated. We'll be watching our monthly surveys of consumers and businesses to get a sense of whether this is likely to be the case, as well as our weekly ANZ card spending data.

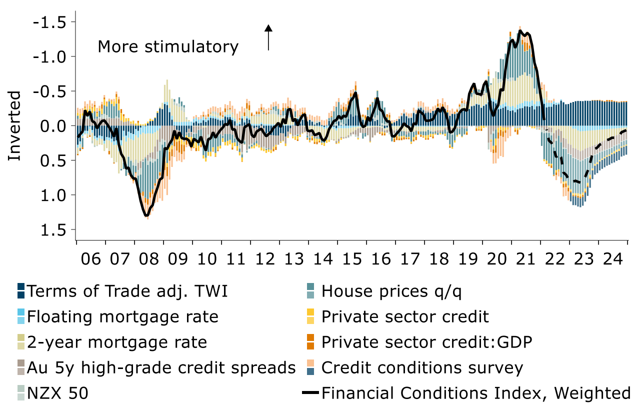
Global risks

The US Federal Reserve is on a mission to cool the US economy to bring inflation down. European growth is under extreme pressure from an energy crisis. China's economy is struggling with both COVID spread and a marked property slowdown. New Zealand's commodity prices are caught in the crossfire of a structural uptrend (increasing water scarcity and food security issues globally) versus a cyclical downtrend (Chinese consumers' impaired ability and willingness to pay). How these things will net out is uncertain, but the potential for a nasty terms of trade shock is certainly there.

It's worth remembering that New Zealand's business cycles don't in practice tend to die of old age, or monetary policy tightening for that matter, but rather get finished off by some side-swipe from offshore. And with interest rates rising rapidly almost everywhere, in a world that had been bingeing on cheap credit and plentiful liquidity, the potential for an accident is high. This could see imported inflation fall sharply. The oil price is already under pressure from China's growth woes; it could tank. That would be a game-changer for the inflation outlook, if sustained (a supply response could be expected, providing an offset).

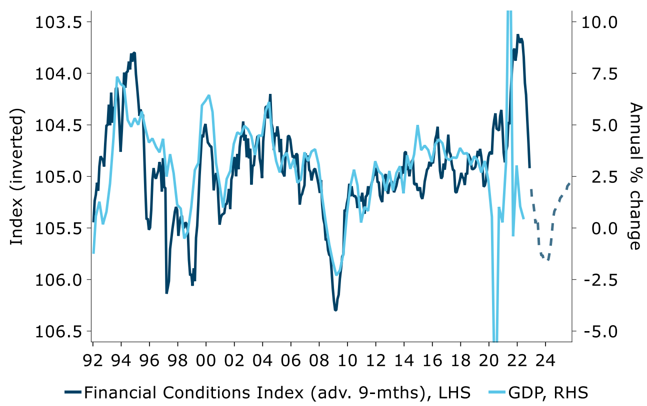
A tightening in financial conditions could also originate offshore, which could impact banks' offshore funding costs. For now, the tightening in New Zealand's financial conditions has been all about what the RBNZ is up to. But if credit spreads increase (light grey in figure 7), there's less work for the OCR to do. Similarly, if the NZD were to appreciate markedly, that would tighten financial conditions. A 10:1 ratio might be as good a rule of thumb as any: a sustained 2.5% increase in the TWI might be worth a 25bp hike.

Figure 7. Financial Conditions Index components



Source: Stats NZ, Bloomberg, Macrobond, ANZ Research

Figure 8. Financial Conditions Index versus GDP growth



Source: Stats NZ, RBNZ, S&P, REINZ, Bloomberg, Macrobond, ANZ Research

Delivering on threats

It's not really a quantifiable risk, but the fact is, it's one thing to forecast hiking into the teeth of a clear economic slowdown because it's the right thing to do for the long-term health of the economy; it's quite another thing to actually do it. Our forecasts assume the RBNZ doesn't blink as evidence of a looming recession mounts and criticism of potential oversteering gets louder and louder. In practice that would be quite something. Getting inflation down and stable from here is a question of accepting definite short-term pain for uncertain long-term gain. Humans typically aren't great at that trade off – just look at noise versus action on the climate change front.

3. Slower-burning risks that could precipitate cuts

Finally, there are downside risks that if they materialised, would likely only do so after we are forecasting the RBNZ to be all done with its hiking cycle. So these risks are less about the peak OCR, and more about whether they could potentially precipitate OCR cuts earlier than expected. However, the RBNZ's ability and willingness to cut the OCR would depend very much on the inflation outlook, not just that of growth. The market is likely to keep overlooking that fact.

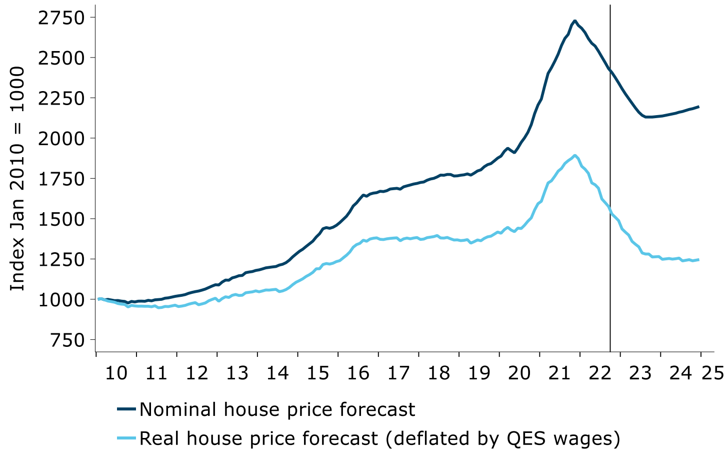
The housing market-unemployment nexus

The RBNZ is aiming to engineer a "shallow" recession next year – but a controlled burn could jump the fire-break. The key vulnerability in the New Zealand economy is the level of house prices – google global housing risks and there you'll find it, in bright red. The good news is that house prices are already down 12% from their peak in an extremely orderly fashion. Very few people have been in a 'must-sell' situation and so have been reluctant to accept sharply lower offers, preferring in many cases not to sell. The prolonged stand-off between wary buyers and offended sellers has resulted in an ideal adjustment path back towards something more sustainable. It's enough to reduce economic growth, certainly, by changing the maths around new builds, but so far, there's very little blood on the floor.

However, the potential exists for nasty feedback loops between the labour market and the housing market. If enough homeowners were to lose their jobs and have to sell at whatever the going price is on the day, house prices could start to gap lower, taking confidence and more jobs with them.

On our current forecasts (a 22% fall in nominal house prices and strong wage growth), the real house price index falls an impressive 32% from its peak. But to get back to 2010 levels (before the angst about housing affordability really intensified) real house prices would need to fall about another 20% (figure 9). So our forecast should certainly not be interpreted as a limit on how far things could go.

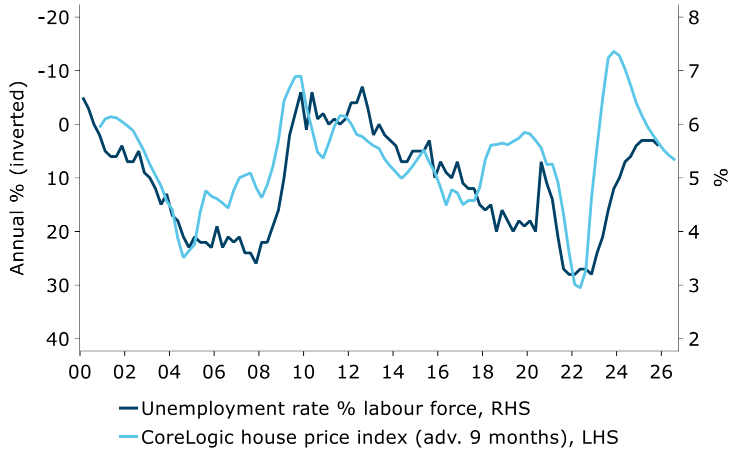
Figure 9. ANZ Nominal and real house price forecasts



Source: Stats NZ, REINZ, Macrobond, ANZ Research

The link between unemployment and the housing market can be seen in figure 10. On the basis of this chart, it's hard to say that the RBNZ's forecasts for such a large rise in the unemployment rate look far-fetched. But of course this chart, being in change terms, doesn't capture the fact that the large house price fall is the unwind of a crazy spike.

Figure 10. RBNZ house price and unemployment forecasts



Source: RBNZ, Bloomberg, Macrobond, ANZ Research

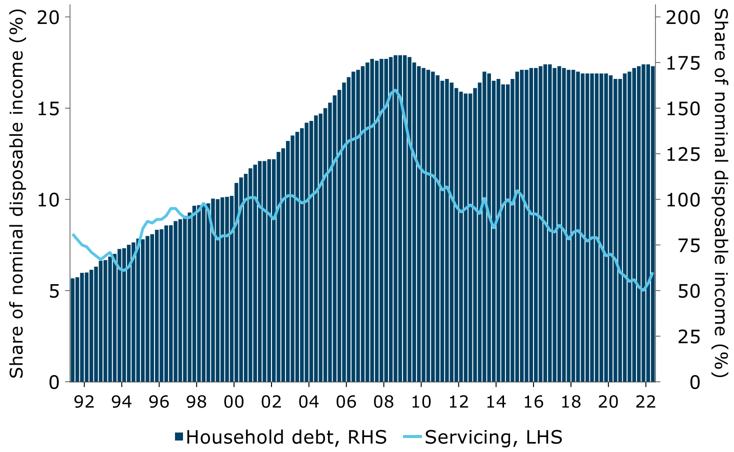
Of course, as discussed earlier, there are risks on the other side for unemployment too, that the labour market could stay tighter for longer than expected. But clearly the housing market slowdown is a risk to the labour market and vice versa, and with every rise in the OCR and mortgage rates, the risk of a harder landing than expected or intended intensifies.

Household debt

This is a mixed bag. Household debt relative to income is certainly high, but it hasn't actually gone up as much as one might think, in the context of the massive housing boom New Zealand experienced in recent years. As figure 11 shows, aggregate household debt relative to incomes is actually considerably *lower* than at the peak of the last business cycle. That's partly due to more prudent bank lending than pre-GFC, and partly due to strong income growth inflating the denominator.

Taking our wage growth forecasts into account, our forecast for a 5.75% OCR would imply the debt-servicing ratio rising to around 11% of disposable income by the end of our forecasts – a huge jump from a low of around 5%, certainly, but far lower than the 2008 peak, and similar to the 11½% implied in Australia by the 3.85% peak in the policy rate our colleagues are expecting there (household debt is much higher in Australia). In short, wage inflation and employment growth mean the mortgage rate the aggregate household sector can handle has been increasing.

Figure 11. Household debt and debt-servicing burden



Source: RBNZ, Macrobond, ANZ Research

But what this chart doesn't show is the distribution of debt. The RBNZ sets the interest rate with the mythical median household in mind, but over the past few years there has been a huge wealth transfer from millennials to boomers. The possible consequences of this deserve digging into more closely, but for now, we'll just note that it could mean that the consequences for spending are heftier than is 'typical', given young people tend to live more hand to mouth. Of course, young people always have higher debt loads, but the extreme house prices in recent years have really skewed the tails of the debt/equity distribution.

Conclusion

It would be nice to be able to say with a high degree of certainty that we know where things are going and what the 'right' thing for the RBNZ to do is. But that's just not realistic. We're in unprecedented times. The RBNZ just delivered its biggest OCR hike ever, at a time when house prices are already down double-digit. But what we can say is that the risk profile is tilting. Though no forecasters have covered themselves in glory in the past year, it has been one-way traffic in terms of forecast revisions. The next 12 months look far more nuanced. At some point, given central banks are having to drive looking in the rear-vision mirror at inflation outcomes, odds are they're going to miss the turn. And the RBNZ is driving faster than most.

The RBNZ deserves kudos for not shirking their responsibilities. Good on them for recognising the scale of the inflation problem, and fronting up to the fact that hoping inflation just goes away is likely to lead to worse outcomes in the end. They are not wrong that the real cost to the economy – ie people – of losing inflation-targeting credibility would outweigh the cost of accidentally causing a harder landing than necessary.

But it's a high-stakes game, and the risk of oversteering at this point is absolutely real. The uncertainty is enormous, and even if policy is actually set perfectly to achieve the best possible outcome, it won't look like it in real time – and will never be known after the fact either. The fact is, as things stand, the choice is between a bad outcome and a worse one. Inflation targeting currently is like that old joke about asking the old man in the village for directions to the post office. "Well, son, I wouldn't start from here."

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