ANZ Research

NZ Forecast Update: OCR Call Change

16 September 2022

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Contact

Sharon Zollner for more details.

Confused by acronyms or jargon? See a glossary here.

More work to do

Key points

- We have changed our OCR call. **We now see the OCR peaking at 4.75%** (previously 4%), with 25bp hikes added to our profile in February, April, and May next year.
- The economy is not rolling over, with the tight labour market and strong wage growth partially offsetting the impact of higher interest rates. The low NZD is also a meaningful offset to current monetary conditions.
- We are not bullish on the growth outlook. The RBNZ needs to see slower growth, and it'll get it. But we think it'll take a higher OCR to do the job. Risks are firmly tilted towards inflation and inflation expectations not falling as far nor as fast as is required to get real interest rates to a sustainably contractionary level, meaning more work for the OCR to do.
- We're making a bigger change to our forecast today at the risk of a flip-flop. So be it; it's what's needed to balance the risks around our central view. Note we are still not including any cuts in our forecasts. While they are of course likely at some point, with global medium-term inflation risks as they are, we don't have a strong conviction we'll see them in our forecast horizon without an unforecastable step-change event.
- If we did see such an event, our sticky core inflation story would pivot from a higher OCR peak to the RBNZ not being able to cut rates as far or as fast as the growth outlook would normally justify.

Taking the economy's pulse

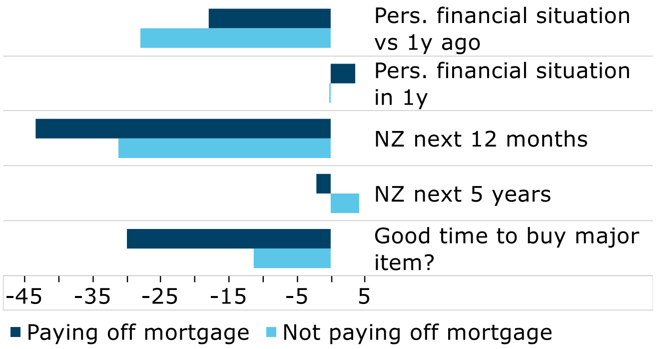
By hiking the OCR, the RBNZ is trying to cool demand to the extent that it drops below (constrained) supply, opening up a "negative output gap". That is, they need to see a fair degree of slack in the economy – including a 5% unemployment rate. It's now a year since interest rates started to lift. Let's step back and look at the recent New Zealand data flow (see chart appendix also).

- Wage growth is at least the highest since 2008 and has yet to peak. The share of jobs receiving a pay rise of greater than 5% has surged to the highest level since 2008. Median weekly earnings were up 8.8% y/y in Q2 2022 – the fastest increase since the data began in 1998. Firms' wage expectations remain very high. The unemployment rate, at 3.3%, is highly inflationary and likely to remain so for at least another year.
- Core inflation measures are all at least 4.8%, and it's unclear that they've peaked. Inflation expectations are off their peaks but not meaningfully lower.
- Monthly employment indicators are holding up.
- While retail volumes are lower, ANZ card spending shows spending on discretionary items like restaurant spending holding up.
- Both business and consumer confidence are lifting from their lows. Firms' four biggest problems are all inflationary: finding labour, costs, wages and regulation. Anecdote is consistent with demand holding up.

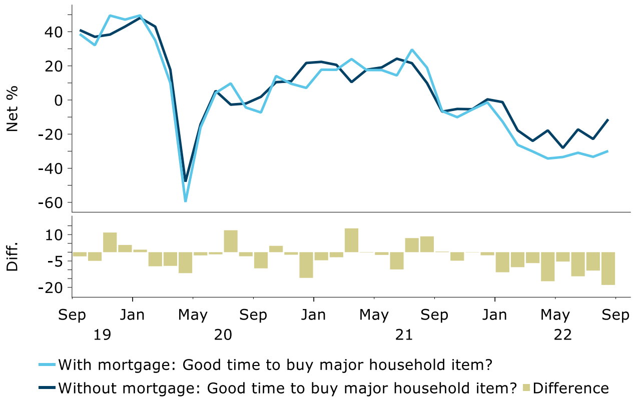
- House prices continue to fall, and are down nearly double-digit, but house sales appear to have found a floor. There are risks on both sides of our forecast for a 15% decline overall.
- The PMI has rebounded strongly and isn't looking remotely recessionary.
- The NZD trade-weighted index has dropped 4% since mid-August.
- Dairy prices are down 26% from their peak, but bounced 5% in the last auction. The outlook is uncertain, as weakening ability to pay contends with structural constraints on global production.
- GDP bounced 1.7% q/q in Q2. While the data is still very messy and volatile, the expected themes of weaker retail but a recovery in externally focused sectors were evident, as an unseasonably high number of tourists arrived once the border opened.

All up, while the growth profile is not strong, it's not clear that beyond the housing market, rate hikes delivered so far are succeeding in opening up much spare capacity in the economy. That requires meaningfully lower household spending. In our consumer confidence survey, those with mortgages were more likely to report that it is not a good time to buy a major household item, but on the other hand, they were more likely to report a better personal financial situation. That likely reflects that those who have houses are typically higher income earners and therefore are being put under less pressure from the lift in the cost of living.

Figures 1 and 2. ANZ consumer confidence survey by mortgage status



Source: Roy Morgan, Macrobond, ANZ Research



Source: Roy Morgan, Macrobond, ANZ Research

The neutral OCR

Of course, monetary policy operates with long and variable lags. Many mortgage holders are yet to roll over onto meaningfully higher rates. So does the RBNZ just need to be patient? Could it be that demand is about to fade more markedly? The answer to that comes down to a question of where the neutral OCR lies – and whether it's on the move.

The neutral nominal OCR is defined as the level of the OCR that's neither expansionary nor contractionary for the economy. It's unobservable, but the RBNZ's latest published estimate is that it is about 2%, implying the OCR is already well into contractionary territory.

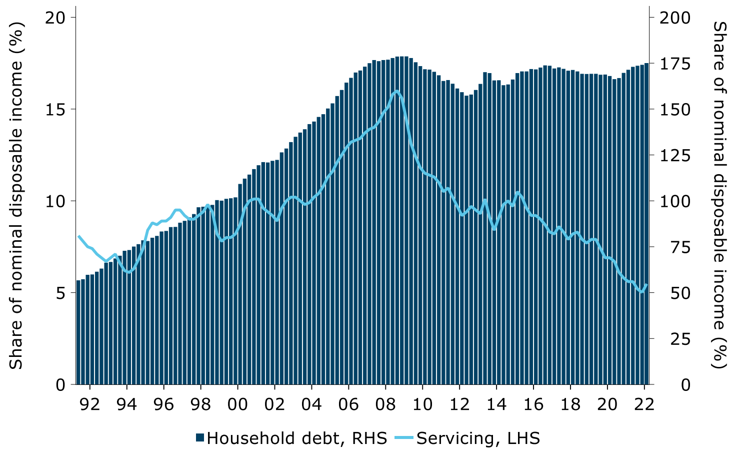
But given how far inflation is above target, expectations that it's going to remain that way for some time, and strong wage growth, it's not unreasonable to think that the neutral OCR is rising. That is, on the street, people's idea of what a "good" mortgage rate looks like is likely lifting as the shock of the abrupt rise wears off and 7% wage growth takes some of the sting out of the increase in both debt-servicing burdens and borrowing capacity.

While both uncertain and unobservable, the neutral OCR matters a lot. If it is indeed lifting, then the OCR is chasing a moving target. It needs to rise along with neutral 1:1 just to stand still in terms of the real contractionary impact it is having. We suspect the neutral nominal OCR is currently around 3%, or at least will be soon. That might sound high, but it's worth noting that unemployment is currently lower (and inflation higher) than in the mid-2000s, when the RBNZ estimated neutral was around 5%.

We are not anticipating that the RBNZ is going to make a sudden step change in their estimate of neutral. Rather, we are anticipating a slow-burn story of inflation pressures just not cooling as quickly as the RBNZ is forecasting. We therefore are predicting a series of 25bp top-ups, rather than a continuation of aggressive double-sized moves.

The mythical median household is actually well-positioned to cope with the consequences for mortgage rates of an OCR rising to 4.75%. As figure 3 shows, the debt-servicing burden is a fraction of what it was in 2008, when the OCR was 8.25%, and still will be at 4.75%. Household debt relative to incomes is actually about the same as it was then, though this statistic masks a large wealth transfer from a younger cohort to an older one.

Figure 3. Household debt and debt-servicing



Source: RBNZ, Macrobond, ANZ Research

The risk outlook

As always, there are many reasons why our OCR forecast could be wrong.

To start with, there are many reasons (some good, some bad) why interest rates may not get as far as we expect.

On the 'good' side, a faster recovery in the supply side of the economy could reduce inflation pressure by relieving capacity constraints. This could come in a few forms, such as global supply chains recovering more rapidly, or a large net inflow of migrants easing some of the severe labour shortages Kiwi firms are experiencing. Net immigration is difficult to forecast at the best of times, and this is clearly not that. It is very difficult to know how the pull of Australia versus the opening of the border (but with tighter policy settings than previously) will pan out. But it is worth noting that the overall impact of net migration on inflation pressure is ambiguous, as it boosts labour supply but also demand for housing and other goods and services.

Another potential 'good side' risks stems from a potentially faster normalisation from the post-COVID concentrated consumption basket. That is, households around the world couldn't spend money on things like travel, so they spent it on goods. That put immense pressure on supply chains and commodity prices globally. And it now appears to be unwinding. While tradable inflation isn't the Reserve Bank's main problem (by a long shot), it can influence inflation expectations and therefore wage and price setting behaviour. That could help take the sting out of sticky domestic inflation pressure a little faster. On the other hand, given climate and geopolitical risks, there are some serious question marks around whether tradable inflation is going to drop sufficiently to return to its previous role as a helpful sub-2% drag on overall CPI inflation in the foreseeable future.

On the 'bad side', it's worth remembering that in practice it tends to be global shocks, rather than domestic monetary policy, that ends New Zealand's economic expansions. And there's no shortage of candidates. There's clearly an economic slowdown in our largest trading partner as a weakening property sector and the ongoing zero-COVID approach continue to weigh on China's economy. Europe has a full-blown energy crisis, and the US Federal Reserve continues to raise rates aggressively. A higher fed funds rate has unpleasant growth consequences well beyond US borders.

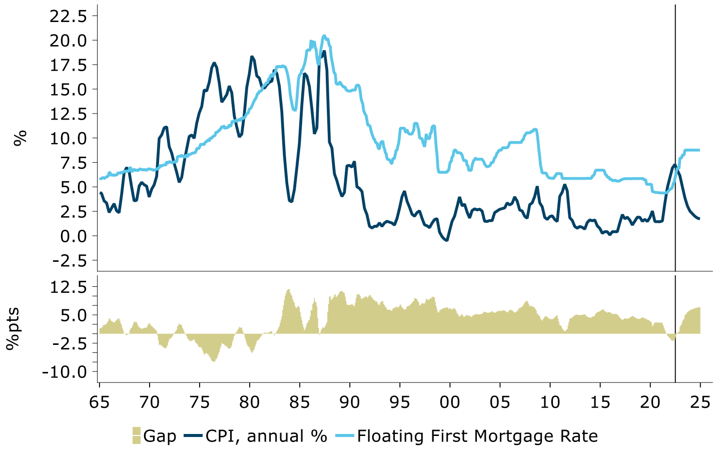
Our forecasts assume slower global growth, but the wheels staying on. Were they to fall off in a way that represented a step-change downwards in the outlook for the New Zealand economy, the expression of our sticky-inflation story would pivot from seeing the OCR peaking higher than currently expected by the market, to the OCR not being able to be cut as far or as fast as the market would likely expect due to inflation still sitting well above target. Central banks analysts are very aware of the mistake made in the 1970s, of easing policy in the face of a weakening growth outlook only to find that inflation did not drop away sustainably as expected, but rather roared away again. The pressure on central banks to cut rates would be extreme, but their ability to do so could be limited.

Domestically, downside growth risks remain very pertinent (eg if construction weakness snowballs). If unemployment rises more quickly or further than expected, the domestic inflation pulse would wane more markedly. But with inflation where it is, the RBNZ can't take these risks into account unless/until they materialise.

Note that we are not revising our growth forecasts down further on the back of this call change (see our post-Q2 GDP update here). Rather, this call reflects a change in our view of how much work the RBNZ needs to do to bring about the required slowdown that is built into our forecasts for the housing market and broader economy.

But while growth risks could see the OCR stop short of 4.75%, there are still risks the OCR could go above that level as well. Real interest rates are currently very low, or even negative depending on which interest rate you are looking at, and whether you deflate by current or expected inflation – and if the latter, whose expectations. For simplicity, the below chart takes headline CPI as the deflator. It can be seen that a hallmark of the stable inflation period has been positive real interest rates – and a hallmark of the inflationary period was real interest rates that were more often negative than positive.

Figure 4. Floating mortgage rates vs. CPI inflation



Source: Stats NZ, RBNZ, Bloomberg, Macrobond, ANZ Research

In our updated forecasts, the OCR rises by another 175bp, from its current level of 3%, to 4.75% by the middle of next year (and we assume that goes into floating mortgage rates 1:1). But headline inflation does a lot more of the work of lifting real interest rates, dropping from 7.3% in Q2 (the last read) to 2% by mid-2024 – that's 530bp of lift in real floating mortgage rates. That highlights that if inflation doesn't fall as far or as fast as our forecast, for whatever reason, then there is still upside risk to our OCR forecast peak, even at 4.75%.

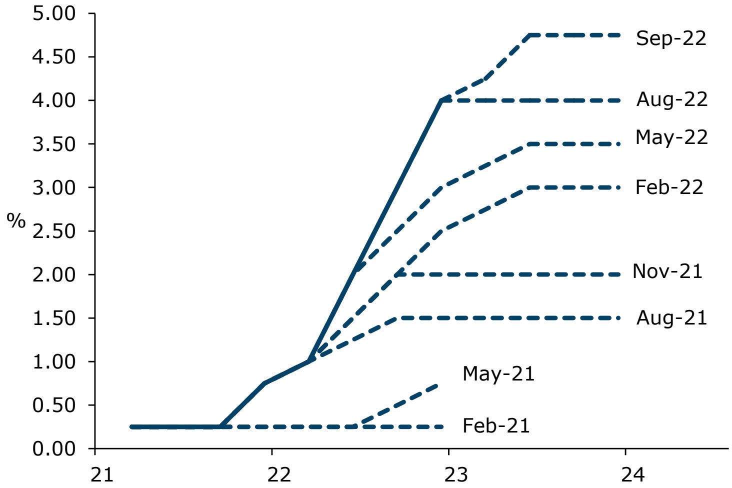
In our view, our updated OCR forecast appropriately balances this risk with the downside risks identified previously.

Finally, a note on the art of economic forecasting. Because forecasters dread flip-flops above all else, forecast revisions tend to be incremental, and serially correlated. Figure 5 shows the revisions to our forecasts since the beginning of last year. (You would not guess from this chart that our calls have on average been a bit ahead of the game over this period.) As in the 1990s and 2000s cycles, the pattern so far has been that the estimate of how far interest rates need to go to head off inflation tends to rise over time – until some game-changing shock comes along and resets the whole picture (Asian Financial Crisis 1998, Global Financial Crisis 2008).

We're making a bigger change to our forecast today at the risk of a flip-flop. So be it; it's what's needed to balance the risks around our central view.

Note we are still not including any cuts in our forecasts. While they are of course likely at some point, with global medium-term inflation risks as they are, we don't have a strong conviction we'll see them in our forecast horizon without an unforecastable step-change event.

Figure 5. Evolution of ANZ OCR forecasts



Source: RBNZ, ANZ Research

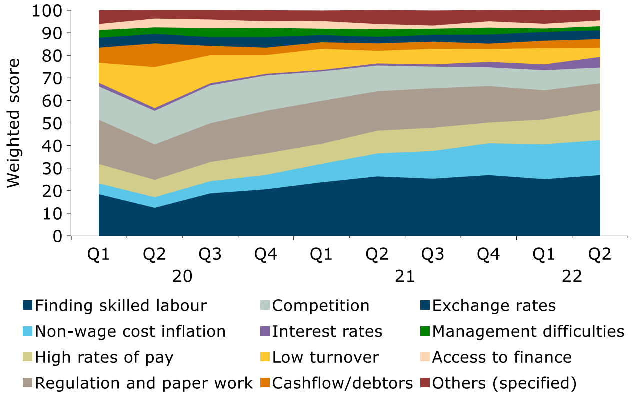
Markets

Our upwardly revised OCR forecasts have significant implications for where we see short-end interest rates going. Short-end rates have been moving up steadily all week, with the 2-year swap at around 4.35% by early Friday afternoon. We think they have further to run, with our new OCR forecasts putting fair value on the 2-year swap at around 4.6%. That's not a lot higher than where the 2-year swap got to in mid-June (4.55%), but back then liquidity was extremely thin, which contributed to the sharp spike. Trading conditions are more settled now. There is of course a range of OCR views out there in the market, and markets often deviate from fair value in any case. As such, we certainly don't expect short-end rates to shoot higher immediately. But we do think we'll see fresh highs as OCR hikes are actually delivered and expectations about what's to follow become more assured.

At the moment, markets are pricing in a peak OCR of around 4.34% in May/July. Beyond that, cuts are priced in. Although it could take some time, we expect rate cuts to get "priced out" as markets focus on the RBNZ's job at hand, rather than second-guessing when the peak will be seen. Our new OCR forecasts leave us more cautious about long-end rates, but these tend to be more reactive to global rates, which have also been rising.

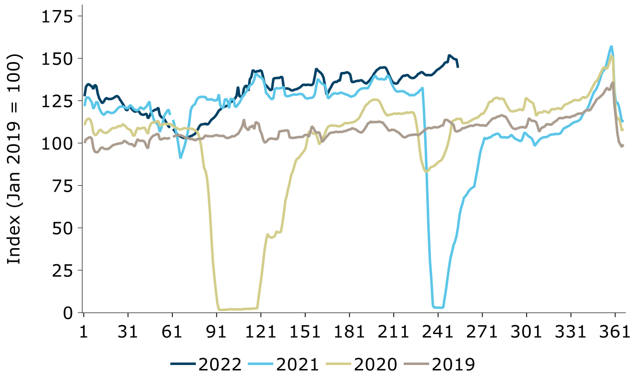
Chart appendix

ANZBO Firms' biggest problems



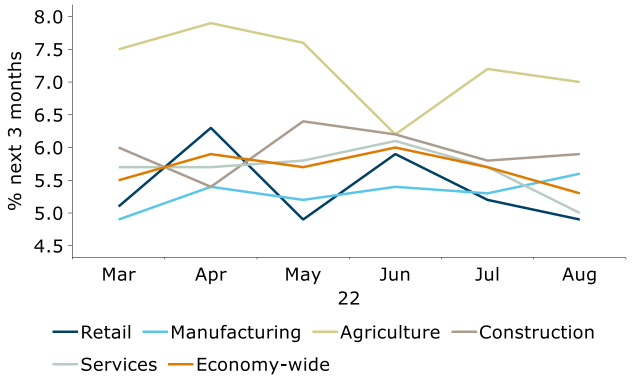
Source: Macrobond, ANZ Research

ANZ card spending data: restaurants and bars



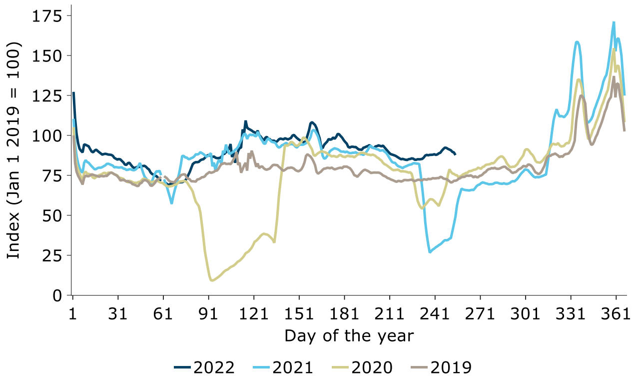
Source: Macrobond, ANZ Research

ANZBO wage expectations by sector



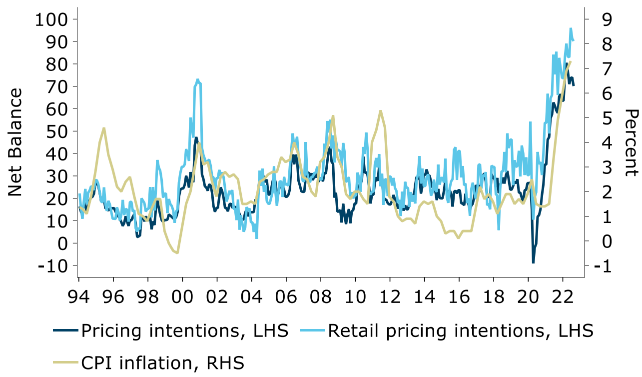
Source: Macrobond, ANZ Research

ANZ card spending data: apparel



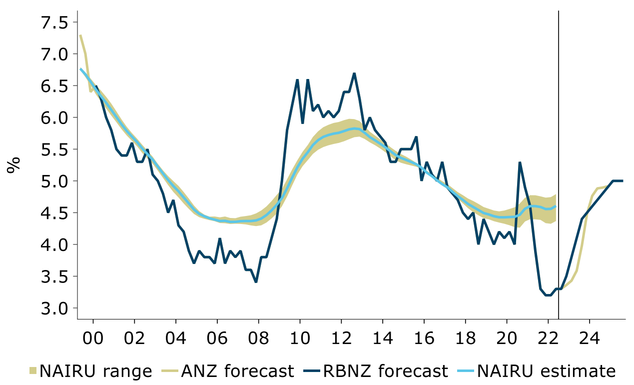
Source: Macrobond, ANZ Research

ANZBO pricing indicators



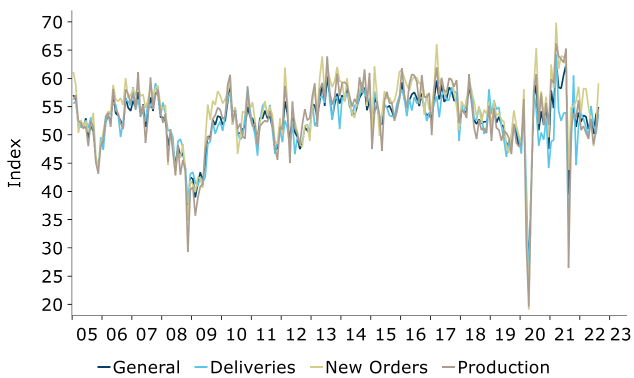
Source: Stats NZ, Macrobond, ANZ Research

ANZ and RBNZ unemployment forecast vs the non-accelerating inflation rate of unemployment



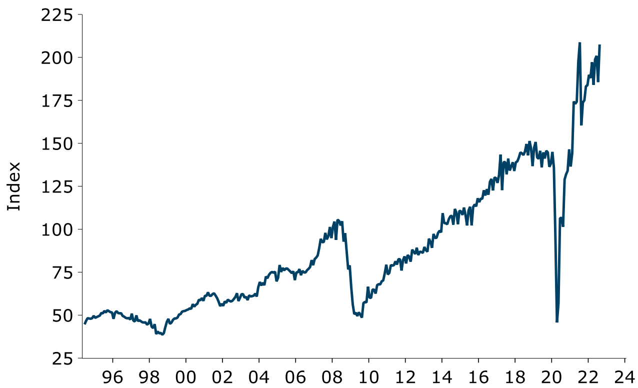
Source: Stats NZ, Macrobond, ANZ Research

PMI



Source: Business NZ-BNZ, Macrobond, ANZ Research

Total vacancies



Source: MBIE, Macrobond, ANZ Research

Contact us

Meet the team

We welcome your questions and feedback. Click here for more information about our team.

Sharon Zollner
Chief Economist

Follow Sharon on Twitter
@sharon_zollner

Telephone: +64 9 357 4094
Email: sharon.zollner@anz.com

General enquiries:
research@anz.com

Follow ANZ Research
@ANZ_Research (global)

David Croy
Senior Strategist

Market developments, interest rates, FX, unconventional monetary policy, liaison with market participants.

Telephone: +64 4 576 1022
Email: david.croy@anz.com

Susan Kilsby
Agricultural Economist

Primary industry developments and outlook, structural change and regulation, liaison with industry.

Telephone: +64 21 633 469
Email: susan.kilsby@anz.com

Miles Workman
Senior Economist

Macroeconomic forecast co-ordinator, fiscal policy, economic risk assessment and credit developments.

Telephone: +64 21 661 792
Email: miles.workman@anz.com

Finn Robinson
Economist

Macroeconomic forecasting, economic developments, labour market dynamics, inflation and monetary policy.

Telephone: +64 21 629 553
Email: finn.robinson@anz.com

Kyle Uerata
Economic Statistician

Economic statistics, ANZ proprietary data (including ANZ Business Outlook), data capability and infrastructure.

Telephone: +64 21 633 894
Email: kyle.uerata@anz.com

Natalie Denne
PA / Desktop Publisher

Business management, general enquiries, mailing lists, publications, chief economist's diary.

Telephone: +64 21 253 6808
Email: natalie.denne@anz.com

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