ANZ Research

RBNZ Monetary Policy Statement Preview

15 November 2022

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Contact

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No low-risk options at this point

Summary

- We expect the RBNZ will raise the Official Cash Rate (OCR) 75bp to 4.25% at its Monetary Policy Statement (MPS) next Wednesday. If there were to be a surprise, a 50bp hike is more likely than +100bp.
- On balance, local data since the August MPS (and particularly since the October Review, when the RBNZ said it considered a 75bp hike) has been firmly on the hawkish side of expectations. The RBNZ has already proven that it's not in the least afraid to go its own way, and the global tilt towards slower hikes is unlikely to play a significant part in the decision.
- We are forecasting the OCR to peak at 5%, via another 75bp hike in February on a "let's just get it done" basis. If data cools more rapidly than expected the RBNZ could well slow the pace at that point. But regardless, we see upside risk to our forecast of a peak 5% OCR, given what's looking like a well-entrenched wage-price spiral at this point.

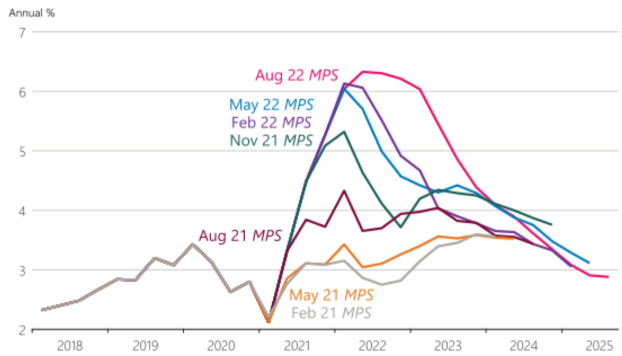
Inflation risks still trump growth risks

The RBNZ in October struck a hawkish tone, noting "it remains appropriate to continue to tighten monetary conditions at pace… Core consumer price inflation is too high and labour resources are scarce." They also noted that they had considered a hike of 75bp, though how seriously is unknown.

The data since then has unfortunately provided a string of upside surprises to estimates of past, current and future inflationary pressure.

- CPI inflation was 7.2% y/y in Q3, versus the RBNZ's expectation of a fall to 6.4%. Both non-tradable and measures of core inflation in Q3 came out smoking, including the RBNZ's sectoral factor model. See our Review. The upside surprises just won't stop, as this chart from the August MPS shows. The latest outturn was 6.6%; add it to the pile.

Figure 1: RBNZ non-tradable inflation forecasts since 2021

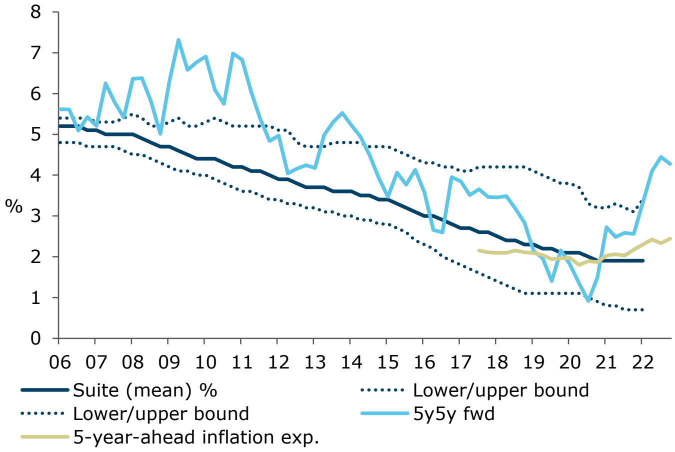


Source: Stats NZ, RBNZ estimates.

- Q3 data certainly showed that the RBNZ's call that "employment is beyond its maximum sustainable level" remains accurate – measures of labour market stretch tightened. And both employment and average hourly earnings came in stronger than the RBNZ had expected, boosting estimates of household income, and thereby making upcoming mortgage rate rollovers less painful than otherwise. See our Review and our Insight detailing the records broken.

- A supermarket chain has recently agreed to a wage increase of 12% y/y backdated to June, and 7% next June. This has the potential to become the benchmark for retail-sector settlements, if not broader lower-end wages. The retail trade and accommodation services industry accounts for 14% of employment. A wage-price spiral is not a risk; it's here.
- Inflation expectations rose further in the RBNZ's own survey (the 2-year-ahead measure rose from 3.07% to 3.62%, and the 5-year-ahead measure rose from 2.33% to 2.44%). Inflation expectations also remain far too high in both consumer and business surveys. It feeds into our suspicion that the neutral nominal OCR is now well above the 2% level built into the RBNZ's forecasting model. All else equal, any move in the neutral OCR translates 1:1 into the required actual OCR.

Figure 2. RBNZ estimated neutral OCR and two of the variables that feed into it



Source: RBNZ, Bloomberg, ANZ Research

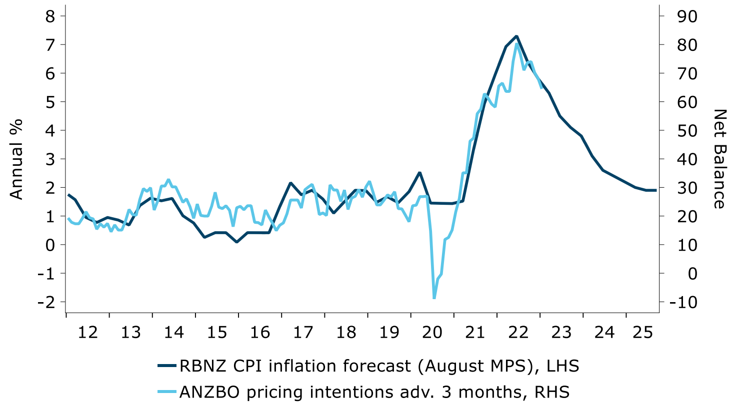
The data isn't one-sided; there are also signs of weakening demand, as one would expect with the OCR having shot up from 0.25% to 3.5% in 12 months flat. However, these data are not inconsistent with either the RBNZ's activity forecasts or our own, which show housing remaining out for the count, construction activity dropping sharply, and consumption seriously running out of steam (after a technical bounce in Q3, we expect consumption to grow only 0.3% in total over the following four quarters).

- The Performance of Manufacturing Index fell from 51.7 in September to 49.3 in October, consistent with weakening global demand. On the other hand, the Performance of Services Index lifted and remains very high, with the employment sub-index bouncing to extremely strong levels.
- The housing market continues to slow meaningfully, but in an orderly fashion, and as expected.
- Fiscal stimulus remains hard to gauge ahead of the Half-Year Update (14 December). But it is perhaps worth noting that the RBNZ's recent review of monetary policy concluded they undercooked fiscal policy's impact.
- The decline in oil prices is worth perhaps -5bp on the OCR track, as is the small downward surprise to dairy prices (certainly a downside risk going forward, but not a new one).

In the category of 'neither here nor there':

- June quarter GDP came in pretty much on the RBNZ's forecast.
- Reported costs and wage and price-setting intentions are off their peaks and pointing in the right direction (though still far too high). But the RBNZ's forecasts include a sharp drop in headline inflation consistent with that (figure 3). It's not a helpful surprise; it's expected.

Figure 3. RBNZ inflation forecasts and ANZBO pricing intentions



Source: ANZ, Macrobond, ANZ Research

- Building consents are not rolling over yet, but the maths (construction costs, falling house prices, and rising interest rates) suggests they will.
- Global inflation pressures continue to wane (shipping costs, supply chain disruptions, commodity prices), as expected.
- The NZD trade-weighted index had been well below RBNZ assumptions but has subsequently recovered to be close to the mark.

There is a huge amount of wiggle room and uncertainty regarding how the RBNZ chooses to interpret the starting point surprises. And then there are strategic considerations as well. So there are lots of moving parts. But all else equal, our back-of-the-envelope estimate is that the news flow since October is worth at least +30bp on the OCR track, and potentially as much as 150bp. That implies a forecast OCR peak of anything from 4.4% to 5.6%. However, outcomes near the top of that range are unlikely to pass the "avoid unnecessary volatility" test. But note if they don't want to show an OCR peak as high as the model spits out, then the alternative is to do more now.

A nice round 5% peak splits the difference and would seem as good a number as any, in terms of sending a clear message that there's a bigger job to be done than thought. We'd expect any cuts implied by the OCR track to be mild and far away, as the RBNZ will not want to see the longer end of the yield curve slump – markets are just looking for an excuse to price a 'pivot'.

It is absolutely possible that the RBNZ might decide another 50bp hike plus a stiff OCR track and some stern words will do the job. But in our view, the risk of a yield curve slump (unhelpfully easing monetary conditions) will be judged as too high for that to be the preferred strategy. We'd put the odds of a 75bp hike around 75% – ie we are well over the line, but it's not a slam dunk.

Both 50bp or 75bp hikes are risky, for different reasons. But when it comes down to it, the odds of a 75bp hike causing inflation to fall below the target band are remote. The odds of hiking too slowly and wishing you'd gotten on with it are relatively high. Don't underestimate what's at stake here: it's not whether inflation gets back to target a quarter or two earlier or later. The Reserve Bank's inflation-targeting credibility is on the line in a pretty binary fashion. From the RBNZ's recent Review of its monetary policy making over the past five years (page 99):

> A survey recently commissioned by the Reserve Bank also raised questions about the likelihood of inflation returning to the target band by 2024. The survey (from a representative sample of 1,000 people) showed that the majority had little or no confidence in the Reserve Bank's ability to bring inflation within the target band by 2024.

In that context, the risk of causing a slightly harder landing than necessary in the economy just can't compete in terms of potential regrets.

Accordingly, we expect the RBNZ to reiterate a hawkish stance – there is little to be gained from doing otherwise at this point. That said, the RBNZ is very good at acknowledging uncertainty and why it could be wrong, and there are plenty of risks out there that we expect the RBNZ to note: around global growth and financial conditions, New Zealand's export prices, and the housing market. But the RBNZ throughout this tightening cycle has played the cards in front of it as opposed to those that may or may not be dealt, and so far, it has no reason to regret that strategy. When the facts change, they'll change their minds. But so far, the facts just keep pointing north, in an ever more urgent fashion.

Markets

If market pricing is similar going into the decision to where it is now, there is clearly going to be some sensitivity to the policy decision itself – ie whether the RBNZ goes for 50bp, 75bp, or as some fear, 100bp. That's because at the moment, market expectations for the November meeting itself sit at 63bps (ie. 4.13%), which is almost exactly halfway between 50 and 75bps. However, much of the easing in market pricing in recent days was in response to a downside surprise to US CPI inflation data last week – and financial markets focus a lot more on US CPI and the Fed than the Monetary Policy Committee (MPC) does. The MPC proved that by going it alone in 2021.

Accordingly, as the focus returns onshore as the MPS approaches we think it's more likely that the market gravitates back towards pricing in something closer to 70bp before the meeting, leaving less scope for adjustment on the day. It seems unlikely the market will seriously back a 50bp hike. While there is genuine uncertainty about the lagged impacts of actions taken thus far, the starting point is just too far out of whack with what was envisaged in August and October.

Looking beyond the immediate decision, as always the track and tone will dictate how the market reacts. On that score, if we get the 75bp hike we are looking for and the track does peak around 5% (or higher), there isn't any realistic scope for any downward reaction in short-end interest rates. Although a 5.12% peak is priced in right now, market expectations for February sit at around 4.69%. Assuming we get +75bp next week, expectations for February are likely to gravitate back up to at least 4.75%, especially if the MPC signal that they're prepared to continue tightening at pace.

Further out the curve, we think the long end will ultimately reward a hawkish tone, but that could take a while to play out. While the initial reaction might see bond yields jump (on higher funding costs), the best thing bond investors can hope for is that the RBNZ stays on the front foot. To put it another way: we'd be worried for bonds over the longer term if the MPC blinks, which they can hardly afford to do now given mounting evidence that we're in a wage-price spiral, dented inflation-targeting credibility, and the labour market as tight as it is.

FX markets are likely to react in the same broad direction as short-end rates – ie the Kiwi is more likely to rise on a 75bp/hawkish decision, but has scope to come off on either a 50bp hike or a less resolute tone.

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Last updated: 1 September 2022

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