ANZ Research

Preview: RBNZ Monetary Policy Review

28 March 2023

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Decelerating hikes in a decelerating economy

Summary

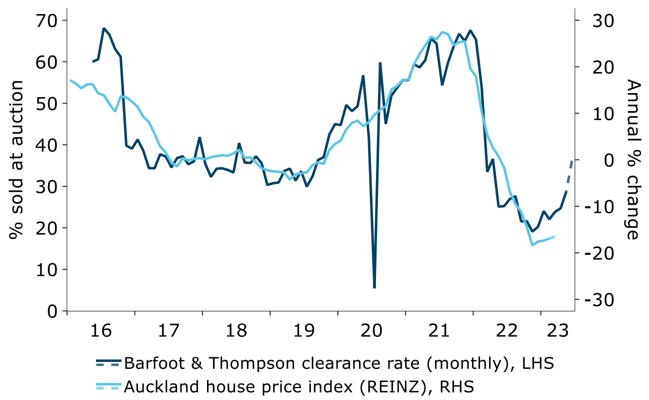
- We expect the RBNZ will raise the Official Cash Rate (OCR) 25bp to 5.00% at its Monetary Policy Review (MPR) next Wednesday. If that's not to be, we see a 50bp hike as likelier than a pause.
- On balance, local data since the February MPS has not convincingly tilted things in either direction. But global financial sector wobbles suggest a degree of caution is appropriate, which the RBNZ can now afford given they are fairly confident the OCR is now in contractionary territory.
- We continue to forecast the OCR to peak at 5.25% with one more hike to come in May.

Still work to do

The RBNZ made it clear at the February Monetary Policy Statement that it believes it has more work to do, with the economy cooling and expected to continue to do so, but starting point inflationary pressures still strong. Domestic data since then has been mixed.

- GDP fell 0.6%, in stark contrast to the RBNZ's expectation of a 0.7% lift. The data showed clear evidence of slowing economic momentum. However, our take is that post-COVID noise and labour shortages mean it would be too simplistic to ascribe all the weakness to the demand side of the equation. It overstates the underlying rate of cooling.
- 'Soft' momentum data (ANZ Business Outlook, PMI, PSI) have continued to recover from their December slump.
- Labour market data has been relatively robust, but some of the recent strength in advertising and hiring could reflect a recovery in labour supply (via migration) rather than reflecting resurgent labour demand.
- House prices continue to fall and are now down more than 16%. However, both anecdotes and the Barfoot & Thompson auction clearance rate (with most of the March data in), are showing some signs of life (figure 1). That particular data appears to be driven primarily by the sudden influx of foreign students invigorating the Auckland apartment market. But even so, it at least suggests that not everyone considers current mortgage rates to be 'high'.

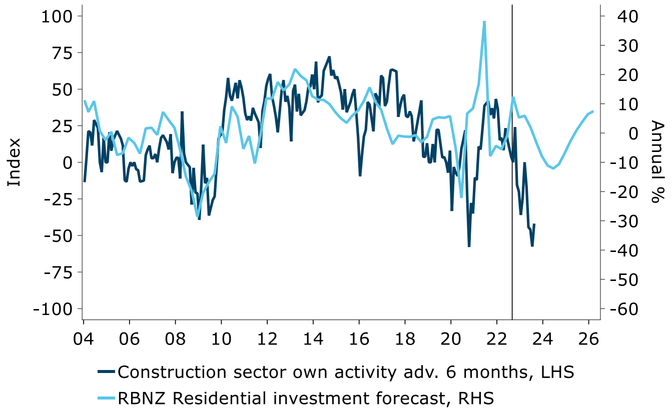
Figure 1. Auckland house price index and B&T auction clearance rate



Source: REINZ, interest.co.nz, Barfoot & Thompson, Macrobond, ANZ Research

- ANZ merchant card spending data remains stubbornly resilient. Annual growth in weekly ANZ card spend has been trending higher in the first three months of this year and is comfortably outpacing inflation. Some of that is tourist spend. Durables and cars are underperforming, as the weaker housing market takes its toll, but all other sectors are running well ahead of the rate of inflation.
- Building consents continue to ease. The ANZ Business Outlook survey suggests downside risk to the RBNZ's forecasts for residential investment (figure 2).

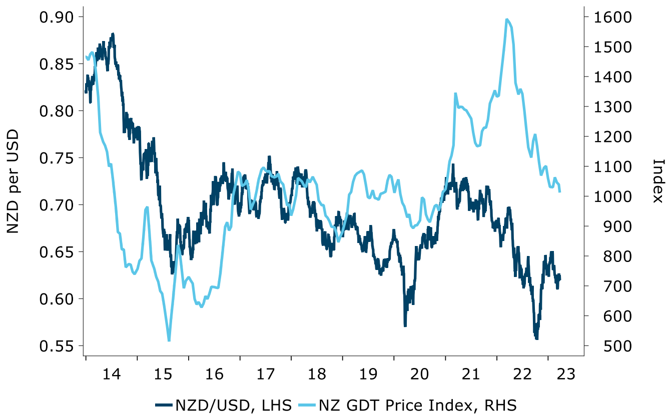
Figure 2. ANZBO construction own activity and RBNZ resi investment forecast



Source: RBNZ, Macrobond, ANZ Research

- Net migration data is noisy and prone to large revisions, but suggests population growth could be substantial at present, adding to labour supply but also demand for goods and services, including housing – immediately.
- Cyclone impacts contributed to food price inflation hitting 12% y/y, led by a 23% y/y lift in fresh fruit and vegetable prices. (Egg inflation is twice that!)
- The current account deficit hit a hairy 8.9% of GDP, highlighting that it isn't just inflation that indicates we need to "cool our jets".
- Dairy prices have fallen, as has the NZD (figure 3). We've revised down our payout forecast for this season and next by 25c.

Figure 3. NZD vs GlobalDairyTrade price index



Source: Global Dairy Trade, Bloomberg, Macrobond, ANZ Research

A bit of a mixed bag, on the whole, not in aggregate making any compelling case to deviate from the plan that was outlined in February: to keep on hiking to 5.5%, leaving options open as to whether a 25bp or a 50bp would be delivered this month.

So why have we plumped for 25bp? The elephant in the room is of course the turmoil in global markets kicked off by the abrupt demise of Silicon Valley Bank and the takeover of Credit Suisse.

It's very unclear at this stage whether the ructions are likely to have any material impact on the outlook for the New Zealand economy. A lot will of course depend on whether the unrest settles down, rumbles on, or blows up. Our forecasts assume things settle down. But if we do see a full-blown bout of risk aversion emerge, there are several channels through which the New Zealand economy could be affected:

- **Risk appetite.** Banks could become warier of lending, not so much retail mortgages, but riskier, capital-hungry types of lending.
- **Bank funding costs.** Deposits are obviously an important source of funding, but since New Zealand is a net debtor nation, banks are obliged to go offshore to make up the difference. So far, proxies for Australasian bank funding costs have not moved much.
- **Global demand for our exports.** As a small, exporting nation, New Zealand's economy tends to do better when our trading partner economies are doing well. The turmoil is seen as increasing the odds of a global hard landing.
- **The NZD.** Our currency has long traded as a proxy for global growth risks, and an 8.9% current account deficit isn't adding to its appeal. If the NZD falls out of bed, that would be inflationary. The RBNZ prefers to look through tradables inflation caused by exchange rate movements, but when the starting point for inflation and, crucially, inflation expectations, is so high, they may not have that luxury.

If the OCR were still far from where the RBNZ estimates it needs to be, the current turmoil would not be sufficient reason to not stay the course. But with the OCR "there or thereabouts", insofar as it is only 75bp away from where the RBNZ sees it peaking, they do have options. A 25bp hike seems a sensible middle ground.

A pause would have two risks associated with it:

1) That the RBNZ is seen as 'going soft' on inflation, seeing the market aggressively price cuts in the fairly near term well before it's clear that the inflation problem is solved, and
2) That it could be counterproductive for confidence, making people wonder what the RBNZ is seeing that they are not.

A 50bp hike, on the other hand, could be perceived as unnecessarily gung ho in what is indisputably a riskier world with plenty of unknown unknowns that could be revealed over coming weeks and months. But if the RBNZ were to surprise us, we see a 50-pointer as likelier than a pause.

Whatever the RBNZ decides to do, and whatever risks they discuss, they will still reiteration their determination to win the inflation fight. They'll take comfort from the fact that they get another crack at it in just six weeks' time. And that the New Zealand banking system couldn't be more different from Silicon Valley Bank.

Markets

Markets are pricing in 90% odds of a 25bp hike next week and a 5.15% peak in the OCR. That's a shade below our forecasts, but feels about right given the skew of risks. While that speaks to a small upward adjustment at the very short end once a hike is delivered, we expect any bounce to be small. Any comments the RBNZ makes about inflation risks, such as how a still resource-constrained economy will be able to cope with cyclone rebuilding, are likely to get somewhat lost amid global financial instability. Even if that calms down, it has ebbed and flowed over the past fortnight and markets are on edge.

Governor Orr has been fond of the phrase "watch, worry and wait", noting late last year that his aim is to get policy fairly rapidly to a point where he can comfortably do that. He has called this his "happy place" (despite the worries!). Exactly where the "happy place" OCR might be remains to be seen, but in the near term, we view the risks to our 5.25% OCR forecast as skewed to the downside given the potential for recent global financial instability to rumble on. As stated earlier, we are forecasting another hike in May. By then we will have the Budget, a clearer picture about the post-cyclone response, and hopefully, the dust may have settled on global financial instability. But in the meantime, there is far less clarity.

There is certainly a case for the RBNZ to echo a hawkish tone purely on the basis of the domestic situation, and we suspect the RBNZ will be careful not to signal that this could be the end of the tightening cycle, or to condone cuts. But this is a MPR, not a MPS, so we won't get a bill track, and that puts the focus on the RBNZ's words, rather than any numbers.

In the absence of the financial turmoil, we'd have said that the risks were skewed to the upside given the domestic inflation picture, rebound in global inflation and PMIs in many countries, and tightness in the labour market. Indeed, as the preceding pages hint at, if we were in a business-as-usual situation, more hikes would be firmly on the agenda given the inflation pulse and other imbalances. That is especially true if one adopts the theoretical hard-line view (that the ECB has taken) that there is no trade-off between price stability and financial stability. But in practice, the lines are blurred, and financial markets are fearful of spill-overs. So too is the Fed, who noted last week that "recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation".

Like it or not, global markets are just far more attuned to the downside risks of financial instability than they are to backward-looking inflation data. That brings with it the possibility that once the OCR gets to 5%, markets might start to question if that's not enough for now. In the eyes of market participants, there is likely to be some neatness to the idea that 5% is a pretty comfortable place for the OCR to be at while the impact of recent turmoil becomes clearer. That's certainly the vibe that's washing through the US market at present, with markets 50/50 on the need for another hike, and pricing cuts after May. New Zealand's inflation backdrop, remoteness from the turmoil and unique factors like post-cyclone rebuilding do pose upside risks, but for now, markets are ignoring these. That vibe certainly hasn't helped the NZD.

To be clear, we don't think the RBNZ will be cutting for some time, but equally, we doubt markets are likely to get back to calling for stiffer hikes (as they were a month ago) any time soon. In time, it may well be that markets start to re-focus on inflation if it isn't dented by financial instability, but that could be months away, and in the meantime, we expect downside fears to dominate market psychology.

We note, for example, that at the height of recent fears, US markets were essentially trying to balance the risks of policy needing to tighten a little more gradually against the need for it to be eased aggressively in one fell swoop. Those are two very binary and extreme opposite outcomes, but as markets lurch from one view to the other (and back and forth!) that's creating significant volatility.

So, to wrap it all up, our sense is that if next week, markets are at similar levels to where they are today, we're likely to see interest rates bounce a touch on what's likely to be a still-resolute tone from the RBNZ. But as in the past fortnight, domestic nuances are likely to get lost in the melee, and we don't expect interest rates market volatility to die down any time soon.

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Last updated: 1 September 2022

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