ANZ Research

RBNZ Monetary Policy Statement Review

24 May 2023

Contact

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As you were

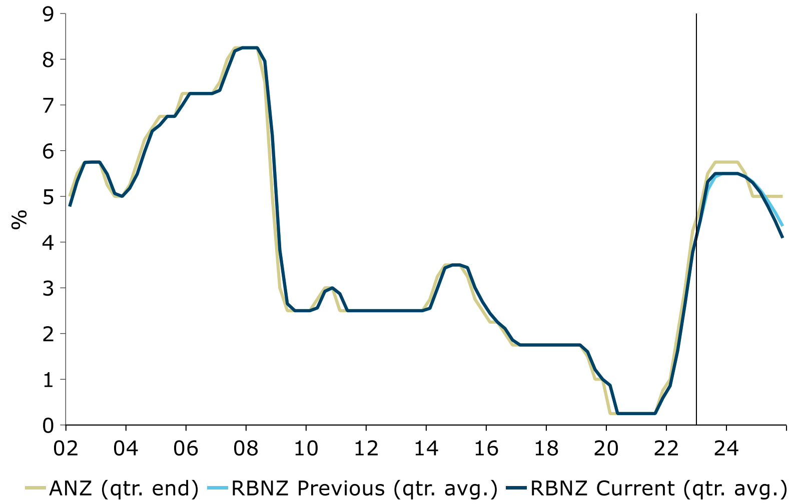
Summary

- As was widely expected, the RBNZ lifted the Official Cash Rate (OCR) 25bp to 5.50% today. However, overall the tone and OCR forecast was not nearly as hawkish as analysts or the market was expecting.
- The RBNZ's OCR forecast is practically identical to that in the February Monetary Policy Statement (MPS). It peaks at 5.5%, suggesting the RBNZ thinks (hopes?) they're done. As before, cuts are pencilled in for the second half of 2024.
- The RBNZ noted that the Committee considered a pause or a 25bp hike, whereas the market and analysts believed they would be weighing up 25bp vs 50bp. It is notable that for the first time, the RBNZ reported that they held a vote, with the decision to hike winning 5-2 over a pause.
- The RBNZ played down migration, noting its impacts are "uncertain". On fiscal policy it noted that it would be "less contractionary" than appeared the case in February. "This is a pretty mild take on things, in our view.
- We see the risks as balanced around our forecast peak OCR of 5.75%, but there is clearly a risk that the RBNZ takes longer to get there than our forecast (another 25bp hike in July). We'll be watching labour market and housing data closely – as will the RBNZ.
- The RBNZ's economic forecasts were little changed from February, with a few offsetting changes.

In brief

As largely expected by analysts, the RBNZ today raised the Official Cash Rate (OCR) by 25bp to 5.50%. The Monetary Policy Statement forecasts no more hikes in the OCR from here. As before, cuts are pencilled in for the second half of next year, with the OCR back down to 3.31% by mid-2026.

Figure 1. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

The overall tone of the Monetary Policy Statement was balanced, but more dovish than either analysts or the market expected. Both were tossing up between a 25bp hike and another 50bp lift, whereas the RBNZ stated in their Summary Record of Meeting that they considered either a pause or a 25bp hike. Interestingly, the RBNZ reported the results of a vote for the first time, with a hike winning 5-2.

The new OCR forecast track is practically identical to that from February, being just a smidgen lower at the end point.

One of the key uncertainties going into the MPS was what the RBNZ would make of the recent surge in net migration. The RBNZ has assumed that the surge will fade away and return to pre-Covid level by 2025, but their assumption for net migration of working age over 2023 has still tripled: it's been revised up from 25,600 in the February MPS to 75,200 in this set of forecasts.

Yet in terms of its impact, the RBNZ has unexpectedly jumped back onto the fence, after describing it as an upside risk to medium-term activity and inflation in the April Review. This appears to have been something of a red herring. The RBNZ noted in the MPS that the net impact of net migration on spending and overall demand is uncertain, but that it is providing some relief in a very tight labour market. These opposing effects mean the inflation impacts are ambiguous. Labour market, housing and inflation indicators certainly remain on the must-watch list in that context – not that they ever aren't!

The RBNZ noted in April that expansionary fiscal policy represented an upside risk to growth and inflation. It's not clear what numbers the RBNZ had in mind going into the Budget, but their conclusion is now that "fiscal policy is projected to be less contractionary than assumed in February." That's a pretty different tone to "inflationary", which is how analysts have generally interpreted it to be, in a stretched economy.

While fiscal policy is projected to add to demand in 2023/24 fiscal year, the effect of high inflation increasing the cost of delivering government services means that real government consumption as a share of GDP decreases across the rest of the forecast period, thereby dampening demand. Real government investment is expected to continue to increase, reflecting the recovery from Cyclone Gabrielle, but capital expenditure is less inflationary than consumption.

We see the risks around our forecast for an OCR peak of 5.75% as balanced. That said, there is clearly a risk that a follow-up hike does not come as soon as July. Retail trade data this morning suggested downside risk to GDP, though the regional breakdown suggests cyclone impacts were very large, suggesting a bounce-back is likely. We'll have GDP and QSBO by the July decision, then CPI and labour market data before the MPS decision.

A non-exhaustive list of reasons the RBNZ may need to keep hiking beyond 5.5% include:

- the risk that house prices could start to lift markedly rather than just plateau;
- that migration could stay high longer than expected; or
- that unemployment might not rise as rapidly as the RBNZ expects.

On the other hand, key developments that could see the RBNZ decide to cut the OCR sooner than the second half of next year include:

- strong migration taking the heat out of the labour market faster than expected;
- the risk of disorder in US markets around debt-ceiling negotiations; or
- inflation indicators dropping away more quickly than anticipated.

The RBNZ no longer seems to believe that a marked economic slowdown is necessary in order to get inflation down. The forecasts feature the tiniest of recessions, with GDP falling 0.2% q/q in Q2, and 0.1% in Q3. Unemployment peaks at 5.4% rather than 5.7%. If a relatively modest slowdown of that ilk is enough to bring inflation sustainably lower, that's a great outcome, relatively speaking. But the RBNZ will be no less data-dependent for being in watch-worry-wait mode. It's worth remembering the experience of 2007-08, when the RBNZ paused twice – for first 6 months and then for more than a year – only to resume hiking. A pause is not necessarily a peak, though the market will undoubtedly take it that way.

RBNZ forecasts in brief

After accounting for starting point surprises (some of which are quite significant), the RBNZ's updated outlook is a touch rosier than the February MPS. The economy is now expected to enter only a very mild recession this year (Q2 GDP: -0.2% q/q; Q3: -0.1%), but that's following a much weaker starting point than the RBNZ previously expected (Q4: -0.6% q/q vs the RBNZ's February MPS forecast of +0.7% q/q). Today's retail trade release for Q1 (1.4% q/q) suggests risks to the RBNZ's Q1 GDP pick of +0.3% q/q are to the downside.

But GDP is noisy right now, and what really matters is what it means for CPI inflation and the labour market. The RBNZ's CPI outlook is little changed, but the expected peak in the unemployment rate is lower, reflecting a higher participation rate and stronger labour supply and employment. The unemployment rate forecast now peaks at 5.4% vs 5.7% in February. See page 9 for forecast comparisons.

All up, these forecasts really aren't that different to the February MPS (after the starting point is taken out). There are some compositional changes (such as more government spending and less private sector investment), but these seem to broadly net out. We certainly agree that risks around activity beyond Q1 are to the upside (upside migration, more fiscal) but we're not so convinced the implications of that for inflation are as muted as presented in the RBNZ's latest forecasts. Time will tell.

Financial markets

Markets went into today pricing in a 34bp hike and a 5.91% peak in the OCR. They were thus caught on the back foot by both the decision itself and the RBNZ's OCR track (which, as noted, still peaks at 5.50%) and moved sharply lower, with the bellwether 2-year swap rate dropping about 35ps in the half hour following the decision. The Kiwi followed suit, also falling by around 70bp. We'd call today's decision a conditional "one and done" outcome, in that the RBNZ is now at its signalled peak, but what happens next depends on both incoming data and global events. Market pricing is still pricing in some risk of hikes, and we don't expect that to change given the upside risks that we and other economists have been flagging. However, with the Summary Record of Meeting noting that MPC members were split 5-2 between hiking 25bp and pausing, it wouldn't take much for markets to price out hikes altogether. But equally, if we were to see mortgage rates fall, markets might worry about that bringing the RBNZ back to the table, so to speak. In other words, expect more volatility.

Official Cash Rate (OCR) set to remain restrictive

The Monetary Policy Committee today voted to raise the Official Cash Rate (OCR) from 5.25% to 5.50%.

The Committee agreed the level of interest rates are constraining spending and inflation pressure. The OCR will need to remain at a restrictive level for the foreseeable future, to ensure that consumer price inflation returns to the 1% to 3% annual target range, while supporting maximum sustainable employment.

Global economic growth remains weak and inflation pressures are easing. This follows a period of significant monetary policy tightening by central banks internationally. International supply chain constraints have also eased following a period of disruption, and shipping costs have declined. The weaker global growth has led to lower export prices for New Zealand's goods.

In New Zealand, inflation is expected to continue to decline from its peak and with it measures of inflation expectations. However, core inflation pressures will remain until capacity constraints ease further. While employment is above its maximum sustainable level, there are now signs of labour shortages easing and vacancies declining.

Consumer spending growth has eased and residential construction activity has declined, while house prices have returned to more sustainable levels. More generally, businesses are reporting slower demand for their goods and services, and weak investment intentions. Businesses report that a lack of demand, rather than labour shortages, is now the main constraint on activity.

There has been a return of net inward migration since international borders reopened. The Committee expects the pace of immigration to ease back toward pre-COVID-19 trend levels over coming quarters. While immigration has assisted to ease labour shortages, its net impact on overall spending is uncertain. The recent recovery in tourism spending, to around three-quarters of its pre-COVID-19 trend level, is also supporting demand.

The repair and rebuild facing significant regions of the North Island — due to the recent severe weather events — will support economic activity, in particular the horizontal construction sector. The timing of this predominantly government investment will be spread over several years. Broader government spending is anticipated to decline in inflation-adjusted terms and in proportion to GDP. The Committee is confident that with interest rates remaining at a restrictive level for some time, consumer price inflation will return to within its target range of 1% to 3% per annum, while supporting maximum sustainable employment.

Summary record of meeting

The Committee discussed recent developments in the New Zealand economy. The Committee agreed that monetary conditions are restricting spending and reducing inflationary pressure. However, current inflation remains high and spending will have to continue to slow to better match the supply capacity of the economy, so that consumer price inflation returns to its target range. While employment indicators reflect easing capacity pressures, they remain elevated.

Global economic growth has slowed below trend for most of our key trading partners. The Committee noted this weakness has been reflected in slowing demand for our goods exports, as seen in lower dairy and meat prices. For a number of years, COVID-19 and the war in Ukraine have constrained global production, disrupted supply chains, and increased shipping costs. These global supply bottlenecks have eased and commodity prices – in particular oil prices – have remained below their peaks in early 2022. Overall, headline inflation is continuing to decline amongst our key trading partners. Nevertheless, core inflation remains elevated in most of our trading partner economies.

Members discussed developments in global financial markets. Recent banking stress in the United States and Europe has been contained by regulators so far but has added to financial market volatility, tighter credit conditions, and uncertainty regarding the global economic outlook. The impacts from these events on domestic financial conditions have been limited to date, and the New Zealand banking system is sound.

The Committee discussed domestic economic developments. Economic activity in New Zealand contracted by 0.6% in the December 2022 quarter. This contraction was unexpected. Business and residential investment and overall government spending contracted in the December 2022 quarter, and domestic spending remained flat. The near-term outlook for activity remains subdued.

In addition, annual CPI inflation was lower than assumed in the February Statement, easing to 6.7% in the March 2023 quarter. Short-term price pressure from recent severe weather events appears to have been less than initially assumed. Both annual non-tradables and tradables inflation were lower than expected, with a reduction in tradables inflation accounting for a larger share of the overall decline in inflation.

Members discussed the evidence that demand is slowing in those parts of the economy that are most sensitive to higher interest rates. The constraining impact of higher interest rates has been most visible in spending and economic activity related to housing. Residential investment has started to ease and falling consent numbers suggest it will continue to slow. Feedback from the industry suggests the pipeline of future building activity is subdued. The rebuild work following the recent floods is assumed to provide a small offset to this decline.

Members also discussed the impact interest rate increases were having on the housing market and household spending. House prices have continued to decline, while first home buyers were accounting for a larger share of new home purchases. Overall, current monetary policy is supporting a moderation in house prices to more sustainable levels. The wealth effects from this decline in house prices have contributed to slowing spending on durable goods since early 2022. In addition, the rate of credit growth for households has declined.

The Committee discussed evidence that elevated interest rates were constraining business activity. Businesses are reporting a general slowing in demand, a weaker outlook for investment, and business credit growth has declined. Businesses are also reporting that orders are now the main constraint on activity – after a period of it being labour availability.

The Committee noted that while the total number of international visitors remains below pre-COVID-19 levels, its recovery since the border was reopened has supported aggregate demand.

Members discussed the recent increase in net inward migration. The projections incorporate a stronger starting point for net inward migration. The Committee discussed what this stronger starting point for migration means for the economy. Overall, it suggests that spending and activity have been subdued, even in an environment of strong population growth. The increase in net inward migration is providing some relief in a very tight labour market, but the net impact on demand – including for housing – is uncertain, as is the impact on inflationary pressure.

Members noted this increase in migration is assumed to be temporary. Migration is assumed to fall back towards the average inflows seen in the years preceding COVID, and settle at an inflow of around 36,000 working age people per year. While the recent increase may partly reflect some pent-up demand to migrate to New Zealand, immigration rules have also been eased to alleviate acute labour shortages in some sectors. The Government recently made it temporarily possible for some migrants on work visas who had already been living in New Zealand for a period to apply for a special resident class visa. Given these new residents would have already been participating in the economy and the housing market as renters, it is expected this change will add only modest pressure to housing demand.

The Committee discussed likely economic impacts of recent severe weather events. Public infrastructure was significantly damaged. Clean-up, repair and rebuild work continues. While estimates are uncertain, the Committee assumes the recovery from these events will add about 1.5 percent to GDP spread out over a number of years.

Members discussed the impact of Budget 2023. Fiscal policy is projected to add to demand over the 2023/24 fiscal year, then dampen demand in subsequent years. Overall, fiscal policy will be contractionary on demand over the projection horizon. This reflects that government consumption, which is the larger share of government spending, is expected to fall as a share of GDP in coming years. Government investment is expected to continue to grow, in part due to the repair and rebuild work in the aftermath of the weather events. Fiscal policy is projected to be less contractionary than the Committee had assumed in February.

The Committee also discussed the functioning of the New Zealand Government bond market. This was particularly in the context of an expansion to the New Zealand Treasury's bond issuance programme, and ongoing sales of bonds in the Large Scale Asset Purchase Programme portfolio. Overall, the market continues to function in line with historic norms. Notably spreads between government bond and swap rates have remained relatively stable.

The Committee discussed the New Zealand labour market. Employment is above its maximum sustainable level. The unemployment rate was 3.4% in the March 2023 quarter, still near record lows. However, same-job wage inflation was weaker than expected. The majority of maximum sustainable employment measures are now pointing to less labour market capacity pressure relative to March last year. Firms are reporting that labour is now less of a constraint to production. In addition, measures of skilled and unskilled labour shortages have eased.

Members discussed inflation expectations. Measures of the inflation expectations of businesses have eased, while household inflation expectations moved higher. It was noted that there was increasing evidence that New Zealand households were putting greater weight on recent past inflation outturns when setting their inflation expectations. This has likely contributed to persistence in domestic inflationary pressure as inflation has risen.

The Committee discussed evidence that monetary conditions are having a contractionary effect on the economy. Members were confident that the interest rates faced by firms and households have constrained spending and investment for some time. This reflects the significant increase in the Official Cash Rate (OCR) that has occurred since late 2021.

The Committee then discussed if monetary conditions were contractionary enough to get inflation back to the 1-3% target in a suitable timeframe. Overall, current mortgage rates and business lending rates were restrictive, supporting a further moderation in inflation. A normalisation in bank funding costs, including increases in retail term deposit rates, is expected to support the maintenance of current mortgage rates. Some households would further limit their spending as they rolled onto higher fixed mortgage rates. Debt servicing costs for households have risen from historically low levels during the pandemic, and are projected to rise further. In addition, the usual lags of monetary policy transmission mean that the full effects of past OCR increases will still take some time to occur.

Members discussed the key economic developments they would need to see in coming quarters to remain confident that lending rates around current levels remained sufficiently contractionary. The Committee noted that the projections incorporate a moderation in inflation and inflation expectations, a continued slowing in household spending growth, and a continued moderation in global inflationary pressure.

Members discussed the key risks to the outlook for activity and inflation. Views on the outlook for the inflationary impact of migration were mixed. Some members saw the risk that strong migration inflows could persist for longer than assumed in current projections and boost spending and inflation. Other members saw the risks as more balanced. In particular, there were not yet obvious signs that high rates of migration were affecting house prices and spending – and there were reasons to believe that current strength reflects pent up demand, and will prove temporary. In addition, migration could further alleviate labour shortages. There has also been a recent change in policy settings in Australia that eases the pathway to citizenship for emigrating New Zealanders. The effect of this on both the quantity and composition of net migration has yet to be seen.

Some members saw upside risk to tourism activity. New Zealand has already experienced a strong recovery in tourism. This has occurred at a time when the arrival of tourists from China has remained weak. A recovery in tourist arrivals from China would add demand in an already supply constrained sector.

The Committee discussed risks around the outlook for inflation expectations, notably the implications of evidence that New Zealand households were putting greater weight on recent past inflation outturns when setting their inflation expectations. Some members noted this could mean inflation expectations fall faster than in past cycles, as headline inflation declines. Others noted this behaviour could be asymmetric on the downside, and core inflation could prove stickier than currently assumed.

Members also discussed risks around the pass-through of past OCR increases to activity and inflation. Some members saw the risk of stronger than expected pass-through. Most notably, a large number of households are still facing the prospect of rolling onto higher fixed rate mortgages. This could constrain spending more than currently projected.

The Committee discussed the reaction to the April monetary policy review decision. The Committee's view in April was that inflationary pressures were still elevated, with little risk of fallout from global bank failures. In addition, the Committee was of the view that rebuild activity following recent weather events would necessitate a rise in government investment. A 50 basis point OCR increase was seen as necessary to support retail interest rates, especially given the fall in wholesale rates that had occurred at the time.

The Committee discussed the stance of policy to be confirmed at this meeting and the outlook for the OCR. The Committee was comfortable with the projected forward path for the OCR. The Committee discussed the suitability of keeping the OCR on hold at 5.25% or increasing it to 5.50%. The Committee agreed that neither decision would cause unnecessary instability in output, interest rates, or the exchange rate.

Raising the OCR to 5.50% is consistent with the projections. This reflects the view that while monetary policy is having a moderating effect on demand at this point in time, a 25 basis point increase in the OCR will increase confidence that inflation falls back to the midpoint of the target band.

The case for keeping the OCR at 5.25% with the same forward projections rested on the recognition that monetary policy is having a sufficiently moderating effect on demand and inflation, and that we are yet to see the full effects of past tightening on the economy. A pause would also allow more time to assess the impact of the significant tightening, and the timing of any further increase that might be needed.

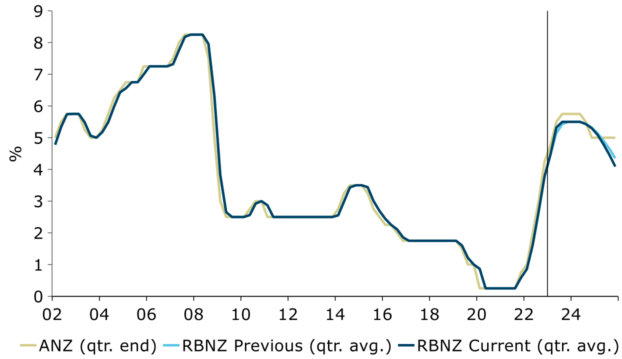
On Wednesday 24 May, the Committee took the decision to vote on the two options. By a majority of five votes to two, the Committee agreed to increase the OCR by 25 basis points from 5.25% to 5.50%.

The Monetary Policy Committee reached a consensus that interest rates will need to remain at a restrictive level for the foreseeable future, to ensure consumer price inflation returns to the 1 to 3% target range while supporting maximum sustainable employment.

Attendees:
Reserve Bank members of MPC: Adrian Orr, Christian Hawkesby, Karen Silk, and Paul Conway.
External MPC members: Bob Buckle, Peter Harris, Caroline Saunders.
Treasury Observer: Dominick Stephens.
MPC Secretary: Adam Richardson.

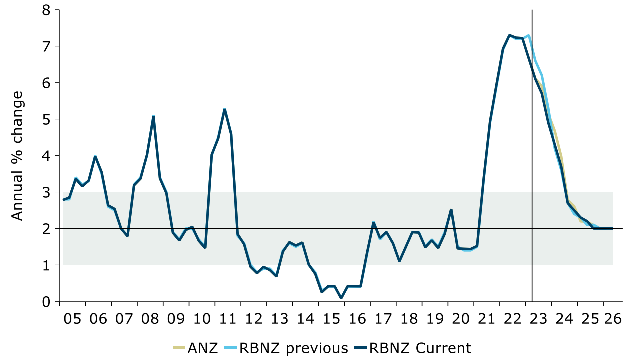
Key forecasts: More starting point surprise than forecast tweak

The RBNZ maintains its peak OCR guidance at 5.5%



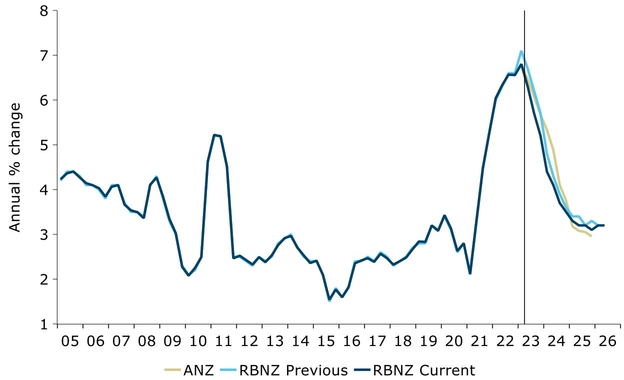
Source: RBNZ, Macrobond, ANZ Research

…with the medium-term inflation outlook little changed

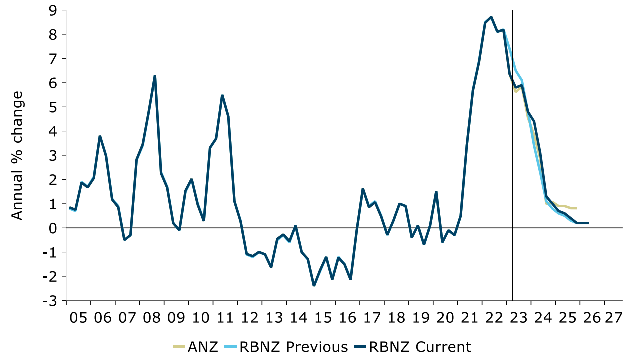


Source: RBNZ, Stats NZ, Macrobond, ANZ Research

…with both non-tradable …

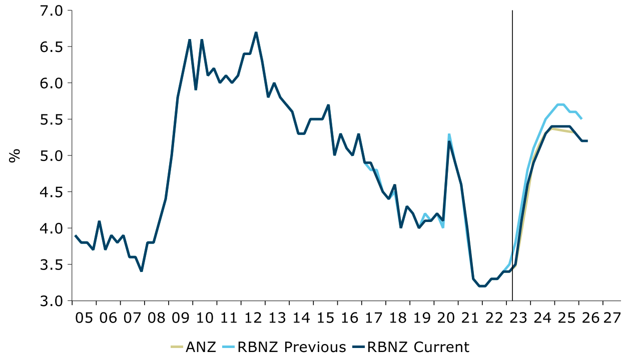


…and tradables inflation also very similar.



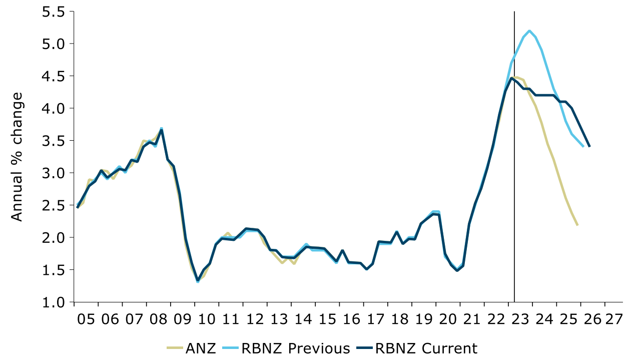
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

The unemployment rate peaks at 5.4%, 0.3%pts lower than previously



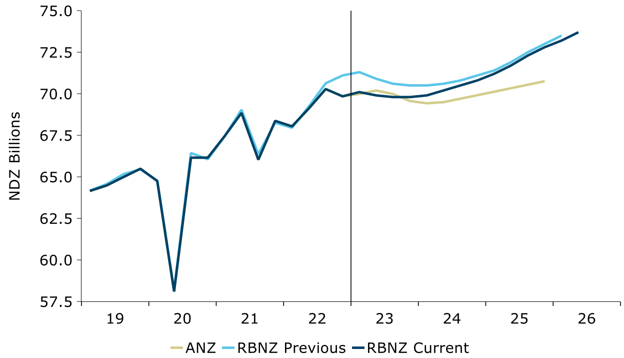
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

LCI wage growth peaks lower, but stays high for longer. Why no boost to non-tradable inflation?



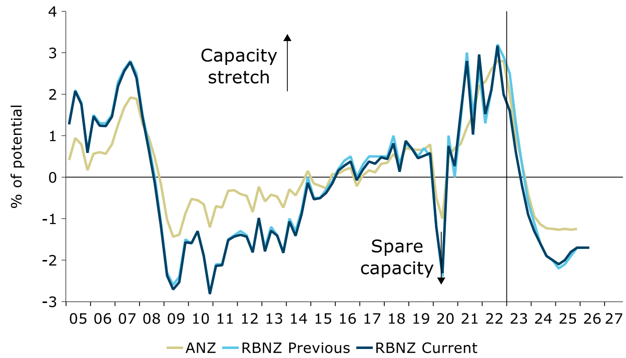
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

GDP forecasts are for more growth, but from a weaker starting point…



Source: RBNZ, Stats NZ, Macrobond, ANZ Research

…with the outlook around spare capacity (output gap) very similar



Source: RBNZ, Macrobond, ANZ Research

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