RBNZ OCR Call Change: 25bp hikes in Feb and April

9 February 2024

Contact
Sharon Zollner for more details.

Confused by acronyms or jargon? See a glossary here.

Out of patience

Summary

- We are now forecasting **25bp hikes in both February and April**, taking the **OCR to 6%**. We are now forecasting cuts from February 2025, ultimately taking the OCR back to 3.5% as before.
- The RBNZ warned in November that "If inflation pressures were to be stronger than anticipated, the OCR would likely need to increase further." Data since then has been a series of small but pretty consistent surprises in that direction.
- In the meantime, yields have fallen substantially. The 2-year swap is 70bp lower than its October 2023 peak.
- Also, at the end of the day, it's worth noting that two more OCR hikes only counter the 50bp increase in the long-run neutral OCR seen in the last two MPSs. Policy is "running to stand still" in that context.
- We see the risks as balanced around our updated forecasts. As we've stated, February is a line-ball call. If they don't hike in February, we think they will in April, unless we start to see meaningful downside surprises. On the other hand, risks are tilted towards cuts coming earlier than February 2025, given we think restarting hiking will have pretty powerful shock value, as it's been widely expected that rates have peaked.
- The RBNZ will be well aware that restarting hiking cycles when per capita GDP is down 3% y/y might appear counterintuitive. But at the end of the day, they have a job to do: to get inflation sustainably down to 2% in the medium term. We just don't think the RBNZ Committee will feel confident that they've done enough to meet their inflation mandate. The buck stops there.

The view

"If inflation pressures were to be stronger than anticipated, the OCR would likely need to increase further" (RBNZ November MPS).

The Reserve Bank's unexpectedly hawkish November Monetary Policy Statement warned that the Committee would likely hike again if there were any more surprises that looked like delaying the return of inflation sustainably to the target band. Indeed, their OCR forecast peak of 5.69% implied that the burden of proof was now on finding reasons *not* to hike, strictly speaking.

A week after the MPS, we penned a note outlining the data to come over the summer, and warned that a February hike was a real possibility. That note has certainly aged far more gracefully than our January OCR call change bringing forward cuts from February 2025 to August this year. While our note certainly hedged its bets, we did capitulate on our long-held hawkish view at precisely the wrong time, just before the data surprises in the other direction started to accumulate.

Data since November

We would characterise the data since November as a cumulation of small but unwelcome surprises. None of them are game changers, but given the starting point was the RBNZ already very nearly over the line to hike again, no game changers are needed. If the RBNZ raises its forecast OCR track even the tiniest smidgen, then their conclusion will be that they should hike.

Recapping data since the November MPS, the RBNZ has seen:

- A downward surprise on Q3 GDP with startling downside revisions that moved the market, but it also showed stronger consumption growth than the RBNZ expected (figure 1), and the disinflationary impacts of the data were downplayed in a late-January speech by RBNZ Chief Economist Paul Conway. The production cut of GDP, particularly goods production, did support the weaker momentum story, with ex-food manufacturing down 10.5% y/y, but Conway's speech didn't go there, suggesting they are still seeing the world as quite capacity constrained.

- A 0.2%pt upward surprise on annual Q4 non-tradable CPI inflation, though headline CPI was weaker than their forecast and there was a decent drop in most core inflation measures, at least those that contain a decent tradables component.

- A mixed bag of capacity indicators in the NZIER QSBO (figure 2). The ease of finding skilled and particularly, unskilled labour soared, but capacity utilisation employment intentions rose.

- Stronger-than-expected Q4 labour market data: unemployment at 4.0% rather than 4.2%, capacity indicators that overall in our estimation went nowhere (figure 3), and a 0.2%pt upside surprise on private sector LCI wage growth. The LCI data also showed that the proportion of firms raising wages, and raising wages more than 5%, continues to look more like a boom than a recession. That won’t do anything to assuage RBNZ fears that inflation is becoming normalised (figure 4).

- Recovering high-frequency activity data, including the ANZBO, the Truckometer and the NZIER QSBO, suggesting a faster recovery in construction in particular. But the PMI and PSI indicators are weak.

- Slightly higher-than-expected net migration, not by much, but it’s relevant because the Committee in November noted “While population growth has eased supply constraints, the effects on aggregate demand are becoming apparent. This is increasing the risk of inflation remaining above target.”

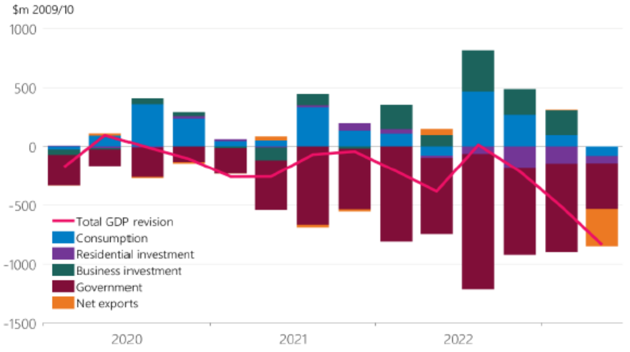
- Very sticky high-frequency pricing intentions and cost measures. In fact, pricing intentions have outright stalled in a pretty worrying fashion for more than six months, and it’s getting pretty hard to ignore (figure 5).

- Meaningfully lower yields, despite the recent back-up (figure 6).

- Recovering export commodity prices, especially dairy. We don’t know what the RBNZ assumed for each commodity, but at first glance the ANZ commodity price index suggests upside risk to their export price assumption.

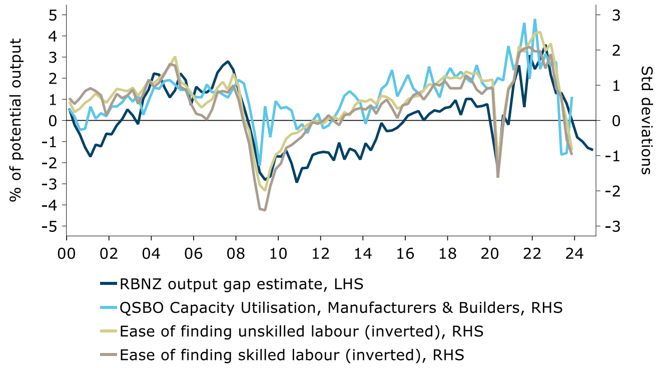
None of those things are dramatically hawkish developments, and none on their own, are a reason to hike the OCR again. There are also data points that have gone the other way: headline GDP, house prices, and the NZD. And forward indicators for growth and employment are hardly ripping away. However, it’s a pretty long list, and in our reckoning it amounts to a higher OCR track from what was already a Nov MPS track on the cusp of hikes.

Figure 1. Contributions to expenditure GDP revisions



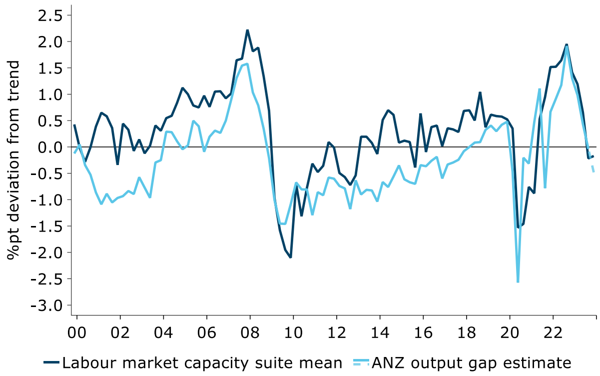
Source: Stats NZ, RBNZ estimates

Figure 2. RBNZ estimate of the output gap and standardised NZIER QSBO capacity indicators



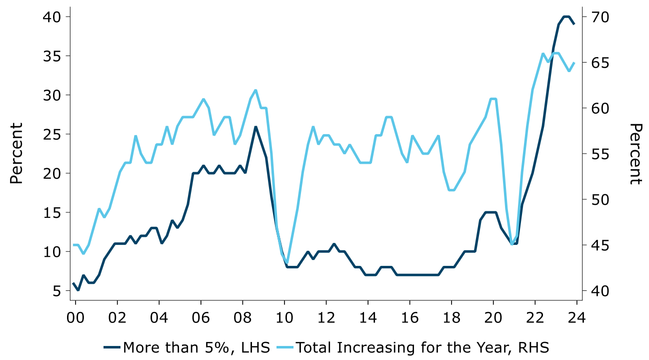
Source: NZIER, Macrobond, ANZ Research

Figure 3. Labour market capacity pressures



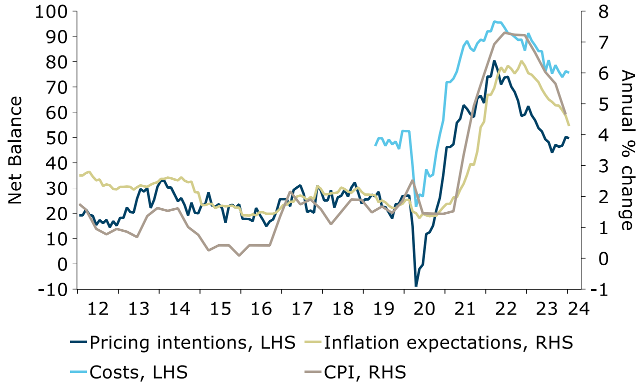
Source: Stats NZ, NZIER, RBNZ, Macrobond, ANZ Research

Figure 4. % of firms giving wage rises, & >5% rises (LCI)



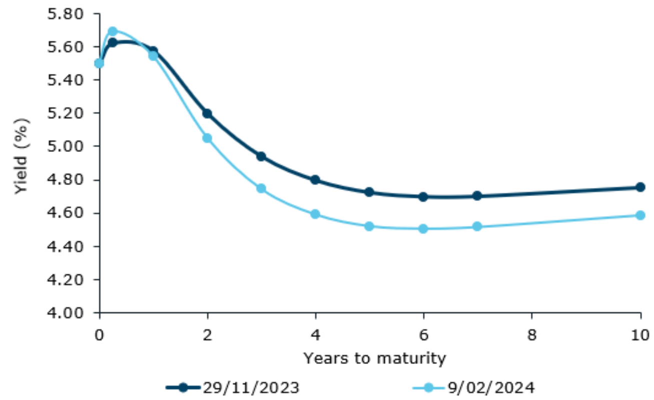
Source: Stats NZ, Macrobond, ANZ Research

Figure 5. ANZBO inflation indicators



Source: ANZ Research

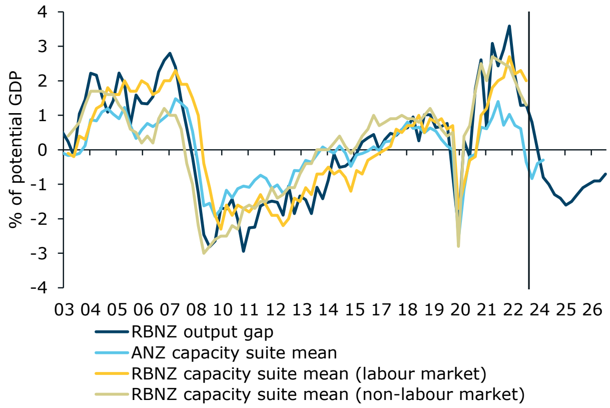
Figure 6. Swap yield curve: as at Nov MPS and now



Source: Bloomberg, ANZ Research

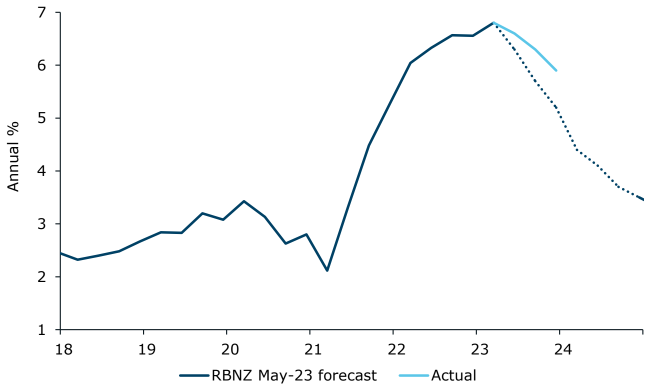
Overall, our capacity suite suggests a risk that capacity pressures might even have *increased* recently (figure 7). Health warning: we haven't got all the data that goes into it yet (Q4 doesn't have GDP-related measures, and Q1 is NZIER QSBO only), and these data may push it lower. (Also note our measure is calibrated to our own output gap measure that uses quite different methodology to the RBNZ's, so one should focus on the lift, rather than the level.) But the RBNZ will be looking at the same data, and if they decide there's a risk that capacity pressures might be rising, that's more alarming than pressures just easing more slowly than anticipated, particularly in the context of non-tradable inflation that has declined much more slowly than the RBNZ thought it would when the Committee called a halt to hikes back in May last year (figure 8).

Figure 7. ANZ and RBNZ capacity suite



Source: RBNZ, ANZ Research

Figure 8. Non-tradable inflation vs. RBNZ May 23 forecast



Source: Stats NZ, RBNZ, ANZ Research

What's still to come?

Between now and the 28 February MPS we have:

- 13 February: RBNZ inflation expectations survey. Likely to decline further. Any increase in the long-term measures would be a red flag.
- 14-22 February: housing data, monthly inflation series, net migration, PMI, PSI, GlobalDairyTrade auction, merchandise trade. Unlikely to move the dial.
- 16 February: A speech by RBNZ Governor Adrian Orr. "Mr Orr will speak about the changing drivers of inflation over the past couple of years and the shift from transitory to more stubborn underlying inflation. He will also discuss why – despite these challenging years – we continue to believe that a flexible inflation target centred on 2% still makes sense." That trailer definitely gives away the movie ending, but hawkish overtones could nonetheless engender a market reaction, given its proximity to the MPS.
- 23 February: Retail sales for Q4 – potentially important given the RBNZ's focus on consumption, but probably too late in the process to make much difference to the RBNZ's forecasts.

All this data will go into the mixing bowl, but it's hard to see the combination weighing up to more downside surprise than we've recently seen on the upside in the data flow.

Monetary policy strategy

The two-sided risks facing the RBNZ remain.

Hike, and the worst-case scenario is that it turns out that the lagged impacts of previous tightening are just about to hit home. Egg meets face, cuts ensue, and the economy will have experienced an unnecessarily large cycle, but rapid cuts should steady the ship.

Don't hike, and the worst-case scenario is that inflation is actually really quite embedded, and interest rates end up having to be raised by much more later, with unpleasant impacts on output, employment, and potentially exporters via the exchange rate.

There's no way to avoid exacerbating one risk or the other. The lessons from the 1990s and 2000s RBNZ business cycle reviews were "don't hesitate to do what's needed". That led to pre-emptive hikes in the 2010s that turned out to be mistakes. But then in the COVID period, the RBNZ should have hiked earlier, with hindsight.

Of course, everything could turn to custard abruptly, but the RBNZ will take a "cross that bridge when we come to it" approach to wild-card risks (geopolitics, weather etc). Fiscal policy is also a bit of a wild card at present, in terms of how spending cuts and tax cuts will balance out. We won't necessarily know much more about that until at least March. But the RBNZ won't make any heroic assumptions about disinflationary impacts.

Finally, some quick counters to the "you've lost the plot" crowd, some of whom may reside offshore.

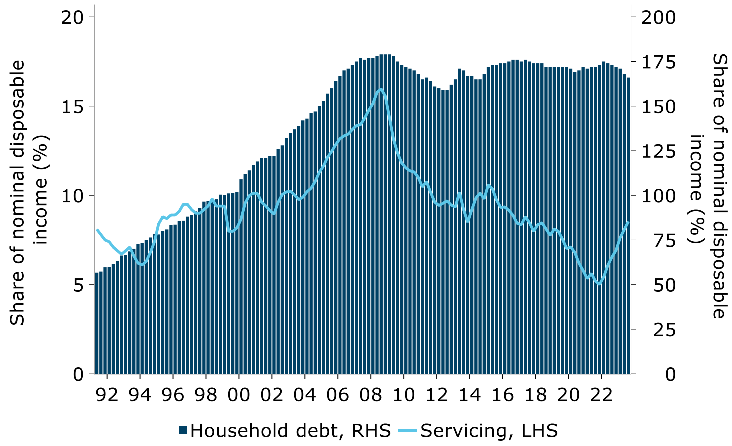
Fiscal stimulus has been far greater and prolonged here than in most countries to which we typically compare ourselves. Migration has been absolutely stonking. We are not famed for being a dynamic, flexible economy. The RBNZ is genuinely facing a tougher job in bringing inflation down than many others, for all that we were shielded from some of the global energy shocks and therefore didn't have the highest inflation peak.

And second, as we've pointed out many times, the OCR isn't anywhere close to its 2008 peak (8.25%), unlike policy rates in the US, the UK, or the euro area. And that's even though non-tradable inflation is *still* more than a percent higher than it peaked in that business cycle, and household debt relative to income is lower than it peaked in 2008 (and falling).

The shock value of the speed of the increase in rates is absolutely real. But rates aren't actually that high. If the OCR stayed at 5.5% the household debt servicing burden would peak around 11% of income, compared to a peak of over 15% in 2008 (figure 9). The RBNZ now estimates that the neutral OCR in 2007 was 5.5%, and non-tradable inflation was running at 4% then, not 6%.

The credit boom in this upswing was in public debt, not private. That doesn't mean it was free. It will lead to tough fiscal decisions from this year onwards. Indeed, if the goal is to balance the books in a reasonable timeframe, then discretionary fiscal settings may need to remain procyclical (ie exacerbating the slowdown after exacerbating the boom). We'll know more after the Budget Policy Statement in March. But the public flavour of the rapid credit growth means that for the consumer, there's been less of a credit hangover than is typically seen after economic booms. The *average* consumer (not all, of course) has experienced meaningful offsets to higher rates in terms of rapid income growth (even if most of it wasn't 'real' in terms of spending power it still counts, as it still improves debt positions) and pretty good job security thus far.

Figure 9. Household debt and debt-servicing burden



Source: Stats NZ, RBNZ, Macrobond, ANZ Research

Bottom line: our OCR call

The RBNZ won't restart the hiking cycle for the sake of 25bp. We therefore see a follow-up hike at the next meeting in April both signalled and delivered, barring unexpected developments, taking the OCR to 6%. The RBNZ may decide to wait until they have more evidence that hikes are needed, of course, and choose rather to talk risks and try to support yields that way. But they did that already in November, with what you'd have to say are mixed results – the market hasn't gone to town pricing cuts, but yields have still fallen meaningfully.

What comes next? Of course if further hiking turns out to be a policy mistake, that in fact domestic inflation pressures are about to wane, then the RBNZ could still be cutting by August.

But even if it's not a mistake, another point to consider is that anecdotes from around the economy are of green shoots emerging precisely because of a widespread expectation that rates have peaked. The shock value of restarting hiking and re-establishing uncertainty about how high rates might go could have a chilling impact on the housing market and investment beyond what '50bp' would normally mean. That wouldn't necessarily mean more hiking wasn't needed. It could just mean it was really effective, and did its job unusually fast.

But assuming the data holds up reasonably well, then the same arguments that prompted the hikes are likely to see rates held high for a decent stretch of time. Call us flip-floppers – we've totally got that coming – but we're going back to calling cuts from February 2025. From there, with the job done, the RBNZ is in a position to cut quickly. Of course, no one can forecast accurately out that far, but consistent with the RBNZ buying itself more assurance of getting the job done with these hikes, we are forecasting a faster series of cuts, still taking the OCR back to 3.5%, the RBNZ's forecast horizon neutral OCR estimate (figure 10).

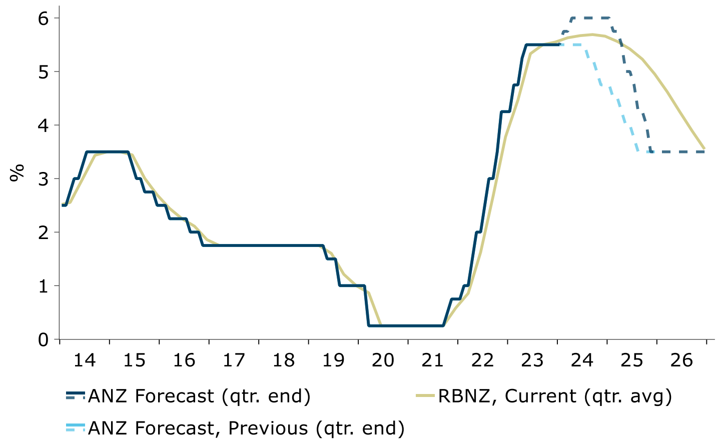
Of course, if there are more upward surprises on inflation, cuts could come later or slower, or more hikes could even be forthcoming. Overall, we see the risks as balanced around our updated forecast.

Markets

Our new, higher OCR forecasts imply further upward pressure for term interest rates, with most of the upward revision coming through at the shorter end of the yield curve, where rates are more sensitive to RBNZ policy. Even though we expect the OCR to peak at 6%, because we also expect cuts from early 2025 (which markets are likely to assume will be delivered sooner), we don't expect the 2yr swap rate to peak anywhere near where it peaked in October (around 5.8%), and instead we expect it to rise to around 5.2%. Very short-end rates like the 3mth bill rate will mechanistically follow the OCR, and they are expected to drift above 6%.

By contrast, long-end rates are more sensitive to global moves, and since our global forecasts haven't changed, our new OCR forecasts imply a wider NZ/US spread, resulting in a lesser lift to our 10yr bond forecasts.

Figure 10. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

Appendix: Historical precedents for hikes following pauses

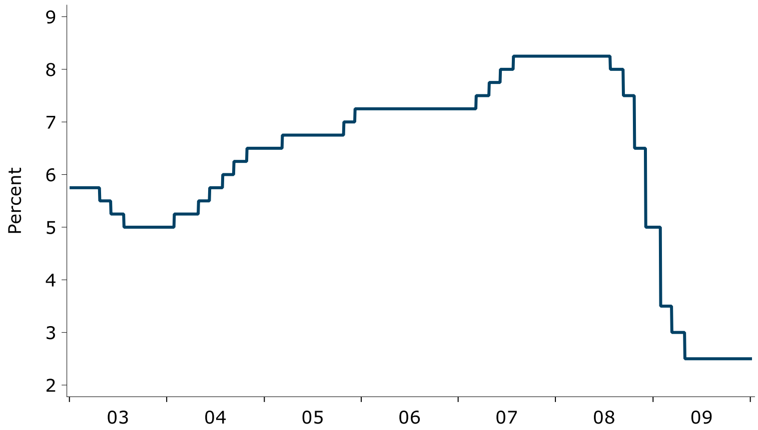
As we have noted many times before, a resumption of hiking after a pause isn't even unusual. In the business cycle ending with the Global Financial Crisis, the RBNZ did it three times.

For an analysis of the macroeconomics of the time, see the RBNZ's Business Cycle Review, 1998-2011. It was quite different from the post-Covid period we find ourselves in – the terms of trade were booming, the NZD was strong, and so too was credit growth. But similarities included expansionary fiscal policy and strong net migration. And non-tradable inflation is far stronger even now than it was at *any point* in that cycle.

In this appendix we'll park the economics to save the thesis, and just take a quick look at the messaging regarding the expected future path of the OCR. The upshot: they weren't bluffing.

Date	Decision	Policy Assessment extract
Jan to Oct 2004	Steady hikes from 5.0% to 6.5%	
Dec 04 to Jan 05	Hold for two meetings	Dec 04: The tightening in monetary policy over the past year currently looks sufficient to keep medium term inflation pressures in check. However, with inflation expected to remain toward the top of the one to three per cent target band over the medium term, **there is little headroom to absorb stronger than expected inflation pressures. If such pressures emerge, a further policy tightening cannot be ruled out.**
Mar 05	**Resumes hiking**: +25bp to 6.75%	With the economy remaining very strong and resources becoming increasingly stretched, we assess that a further tightening of policy is now necessary. … Being prudent now reduces the prospect of a tighter monetary policy later on.
Apr to Sep 05	Hold for four meetings	Jun 05: Overall, we assess that the balance of inflation risks remains on the upside… **further tightening in monetary policy would likely be required if there are upside surprises to the inflation outlook.** Sep 05: We are concerned … that the risk of higher medium-term inflation has increased. Consequently, **further monetary policy tightening may still prove necessary.**
Oct to Dec 05	**Resumes hiking**: Two 25bp hikes to 7.25%	Dec 05: Whether further tightening is needed will depend on the extent to which housing and demand pressures show signs of moderating over the months ahead.
Jan 06 to Jan 07	Hold for nine meetings	Jan 06: we do not expect to raise the OCR further in this cycle; however, this possibility cannot be ruled out until we see clear evidence of a sustained weakening in domestic demand. Mar 06: As long as these inflation risks remain under control, we do not expect to raise interest rates again in this cycle. Sep 06: Given the continued strength of medium-term inflation pressures, the outlook for monetary policy has become more finely balanced. With inflation now taking longer to move comfortably within the target band of the Policy Targets Agreement (PTA), there is little leeway to withstand further surprises to medium-term inflation pressures. In these circumstances, **we are less confident that no further policy tightening will be required in this cycle**. Dec 06: Looking ahead, our projections and risk assessment suggest that **a firmer monetary policy stance could still be required to maintain downward pressure on inflation in the medium term. Further tightening cannot therefore be ruled out.** Jan 07: **it is likely that further policy tightening will be required.** The situation will be reassessed in the light of a full review of our economic forecasts at the March Monetary Policy Statement.
Mar to Jul 07	**Resumes hiking**: 4 hikes to 8.25%	Mar 07: Depending on the persistence of the current upturn, further tightening may be required. Jul 07: New Zealanders have been showing early signs of moderating their borrowing. Provided they keep this up, and the pressure on resources continues to ease, we think the four successive OCR increases we have delivered will be sufficient to contain inflation.
Sep 07 to May 08	Hold for 7 meetings	Sep-07: The outlook for economic activity and inflation has become more uncertain ... Credit concerns and heightened risk aversion have led to significant turbulence in global financial markets.
Jul 08	GFC cuts begin	

Figure 11. The OCR 2003-2009



Source: RBNZ, Macrobond, ANZ Research

For comparison, here's what the RBNZ said in the November 2023 MPS:

Policy Assessment: The Committee is confident that the current level of the OCR is restricting demand. However, ongoing excess demand and inflationary pressures are of concern, given the elevated level of core inflation. If inflationary pressures were to be stronger than anticipated, the OCR would likely need to increase further.

Summary Record of Meeting: Some members noted that inflation has now been above target for some time, and that there should be a low tolerance for any increase in the time to return inflation to target

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