ANZ Research

RBNZ OCR Call Change: First cut in February

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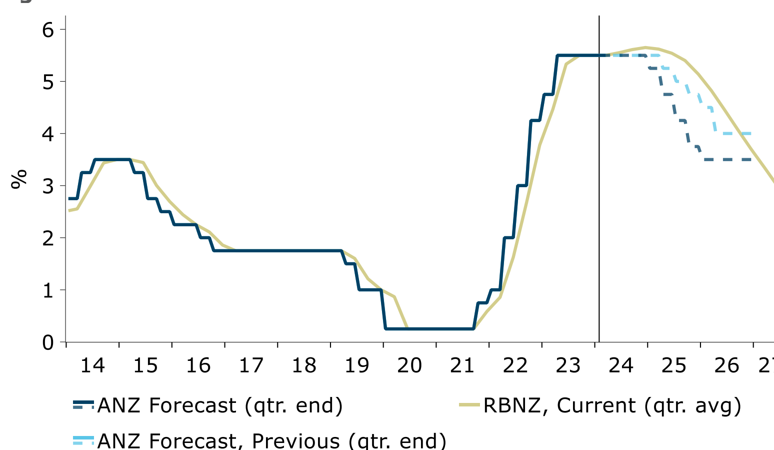
OCR call change – First cut in February rather than May

Summary

- We have tweaked our Official Cash Rate (OCR) forecast and **now expect the first OCR cut to come in February 2025, rather than May**.
- The RBNZ's concern about the run of higher-than-expected domestic inflation is understandable, but we expect that meaningful progress is around the corner. The real economy is very weak and given the vibe of "soft data" (surveys, leading indicators and the like), we are now more confident in the weak economic outlook enshrined in our most recent Quarterly Economic Outlook. We've been talking for some time about the risks being tilted toward cuts starting earlier than May; we are now rebalancing the risks by moving our forecast to February.
- Before cutting the OCR, the RBNZ needs to not only be confident that CPI inflation is on its way to 2%, but that it can be reasonably expected to subsequently stay within the 1-3% target band. Various combinations of activity and inflation outcomes could meet those criteria. But by February next year, we are anticipating that the RBNZ will have seen Q4 CPI inflation at 2.6% y/y (non-tradable still 4.7% y/y, but we are forecasting it to drop sub-4% the following quarter), and unemployment through 5%. That should do it, in our view.
- We currently see the risks as balanced around our updated February forecast, but we fully expect markets to continue to front-run easing as the labour market deteriorates.

Figure 1. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

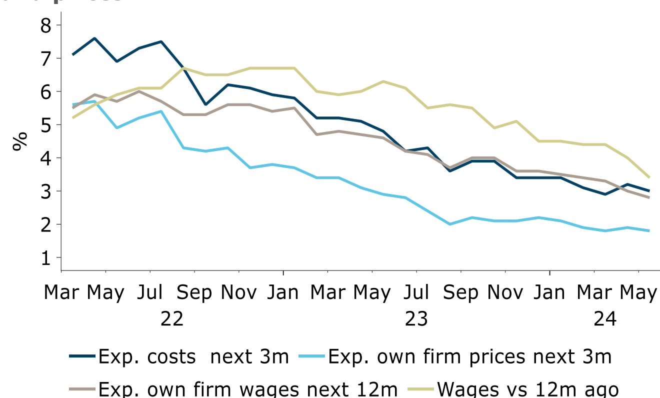
The Reserve Bank surprised markets – and to a lesser extent, economists – with their hawkish tone at last month's *Monetary Policy Statement*, publishing an OCR track featuring a slightly higher peak and later OCR cuts (with the first cut pushed out from May to August next year). The reasoning: much slower-than-expected progress on reducing non-tradable

inflation (which fell from 5.9% to 5.8% y/y in Q1, versus the RBNZ's forecast of 5.3%), which together with weak productivity data saw the RBNZ conclude that the economy's speed limit of non-inflationary growth is likely lower than previously thought. That implies there is less spare capacity currently and therefore less disinflation in the pipeline.

However, for our part, we have become more confident on that front, rather than less. We put a lot of store in the inflation indicators in our Business Outlook survey. In addition to the tried-and-true indicators, in recent years we've added some interesting new questions, the answers to which are telling precisely the story the RBNZ needs to hear.

Wage settlements – actual and expected, as well as firms' expected costs and pricing decisions, have fallen steadily (figure 2). Because most of these series are so new, we can't draw any conclusions about the level of inflation they imply lies ahead, but the decline is encouraging. That said, it is also notable that firms' expectations of how much they will lift their prices in the next three months have been going sideways for about eight months at around 2% q/q. Figure 3 shows that the net proportion of firms expecting to raise their prices, while still high, last month finally broke out of the plateau it has been on for 8-9 months. And we are optimistic that the net percent of firms expecting higher costs will drop away along with wage settlements over coming months. It's certainly all taking its time, and the indicators are not supportive of imminent rate cuts. But they're getting there.

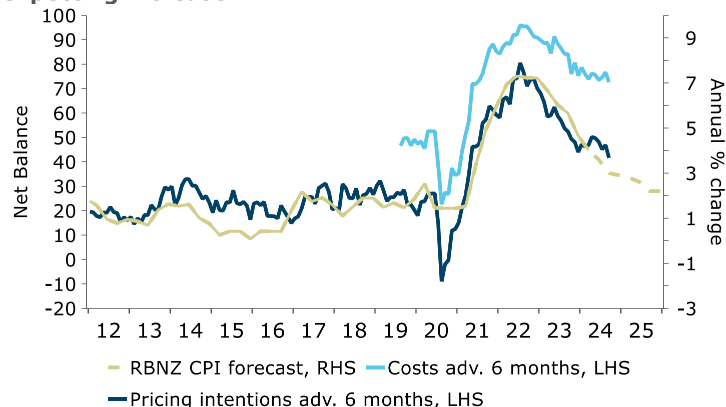
Figure 2. Actual & expected wages, expected costs and prices



Source: ANZ Research

Note that there is a mix of q/q and y/y changes in the chart.

Figure 3. Expected costs and prices: net % of firms expecting increase



Source: RBNZ, Macrobond, ANZ Research

We'd characterise the long stall evident in some of these measures as a break between the 'easy' disinflation (the unwind of higher oil prices, shipping costs, and cyclone-induced food price inflation) and the much tougher 'take your medicine' phase (customers can't stomach price rises; firms can't afford and don't need to give large wage increases; firms are forced to discount goods and services to encourage cautious consumers to buy). It's not evident in the non-tradable inflation data yet, but the soft data (our survey, anecdotes etc) suggest phase 2 is well underway.

At the same time, the housing market is currently moribund (see our Property Focus), anecdotes and stated intentions re investment and employment are weak, and card spending is weakening again after a lift in the first few months of the year. And oil prices, though certainly not something the RBNZ can rely on to do the inflation-fighting job for them, have fallen around 13% since their early-April peak, which will be helpful for the tradable inflation outlook if sustained.

The economy is clearly weak. We have a new timely GDP indicator in our Business Outlook survey that asks about activity in the past month versus a year earlier. It is suggesting perhaps a little upside risk to the RBNZ's Q1 GDP forecast (0.2% q/q, 0.3% y/y) but the opposite in Q2.

So, if the RBNZ is winning, why not cut already in November or even as soon as August?

We would characterise **August** as very unlikely at this stage, barring a big negative shock, not least because there will only be one more CPI print by then and Q1 GDP looks likely to be (relatively) respectable. **October** is unlikely as the RBNZ prefers to kick off new policy directions at Monetary Policy Statements, where a full set of forecasts can explain the justification, rather than the in-between brief Reviews.

November is entirely possible if the economy, housing and labour market are still looking soggy and there has been meaningful progress in getting non-tradable inflation lower – particularly given the long break before the next meeting in February. But at this stage we see February rather than November as the likeliest timing as there are several key uncertainties that the RBNZ needs a lot more clarity on, which will take time.

- Will the tax cuts and other income-supplementing fiscal measures be inflationary? Our base case is that the RBNZ will be relatively sanguine about **the net impact of tax cuts**, given our back-of-the-envelope suggests the cost-cutting measures will outweigh them in terms of overall activity. The RBNZ may reach a different conclusion, given their focus on consumption. In any case, if the Committee considers net fiscal stimulus a key uncertainty for the outlook, that speaks to waiting for more evidence of the impact.

- Does this disinflation path the economy is on lead **all the way to 2%?** There is still a scenario where inflation levels out at or above 3% in the medium term. Even if non-tradable inflation starts behaving itself, global inflation may not. As noted, oil prices are currently easing, but shipping costs are not. The global trading environment is deteriorating as tariffs and non-tariff barriers become more common, and food supply shocks are becoming more frequent due to extreme weather events.

- Once the dust settles on the ferocious *lift* in the Official Cash Rate, how contractionary is the *level* of 5.5%? Would it put people off buying an investment property? Would it put firms off investing, if the economy were on a more even keel? Where **the neutral OCR** is estimated to be will have a significant say in how soon, how fast and how far the RBNZ cuts, and their estimate of where it lies is subject to constant revision. It's worth noting that the RBNZ's range of model estimates of the current short-term neutral OCR (3% to 5.5%) effectively covers scenarios from the economy starting to recover shortly without any OCR cuts at all, through to spiralling downward. The market is focused on the latter possibility but the RBNZ will weigh up risks on both sides.

- **Stickiness in non-tradable inflation** is real and some of it is likely to persist, as we discuss in this insight note. But our take is that it largely reflects a lagged response to past inflation in both prices and wages, rather than being indicative of more capacity pressures across the economy than thought (the RBNZ's May MPS interpretation). But even if we're right, the RBNZ will remain wary as long as there's a risk that disinflation progress could continue to be slower than expected.

- Will **the housing market** stay asleep? That's certainly our forecast, for well-understood reasons. But the Auckland housing market in particular does have a proud history of surprising everyone. The most leading indicator, the Barfoot and Thompson auction clearance rate, seems to have found a floor. If the market starts to price cuts more aggressively seeing fixed mortgage rates fall, and that results in stirrings in the housing market in the spring, that may make the RBNZ less inclined to cut the OCR promptly.

- **Unemployment**. Since the last OCR hike in May last year the RBNZ has generally been surprised by the resilience of the labour market. We now see the risks as tilted towards unemployment rising faster and/or further than their forecasts. Either way, unemployment is a must-watch, as it goes straight into the RBNZ's estimate of spare capacity and thus pipeline inflation pressure.

2025 and beyond

Beyond February, we have simply pencilled a 25bp cut at each meeting. The speed of cutting is not something we have a strong view on at present. Our forecast cuts stop with the OCR at 3.5%, ie neutral or thereabouts. Obviously if things really unravel the RBNZ is likely to be cutting much more quickly, and on the other side, if inflation doesn't get all the way to 2% (or bounces meaningfully), cuts may come more slowly or cease.

In terms of the risks around where rates ultimately settle (noting of course than in practice equilibrium is a purely theoretical construct!), to the upside we're mindful that sticky global inflation could mean it takes higher average interest rates to keep CPI inflation as low as it has been in the past. Conversely, we're mindful that a negative economic shock could come along, necessitating an OCR well below neutral for a time.

Conclusion

In our view, inflation data will soon start to make a more convincing case that the RBNZ is winning this war. We also expect that the RBNZ will take quite some convincing to actually cut the OCR, given it's in the nature of their mandate to be cautious when assessing the outlook for inflation. However, we believe that point is likely to be reached well before August next year, which is the RBNZ's current forecast for the first OCR cut.

We see the risks as currently balanced around our updated call, but expect the market to continue to punt on cuts this year. Some in the market believe that the RBNZ is to some extent bluffing in order to prevent the market front-running cuts too aggressively. But even discounting that possibility, the knowledge that the RBNZ always reserves the right to change its mind as the data unfolds will no doubt ensure that the market continues to take what the RBNZ says about the path of policy so far ahead with a grain of salt, and make up their own minds.

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