ANZ Research

Preview and OCR call change: RBNZ Monetary Policy Review

2 October 2024

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Taking what's on the plate

- **It's going to be a close-run thing, but now that most economists are calling it and the market is pretty much fully pricing it, one has to conclude that on balance the likeliest scenario is that the RBNZ will just take what's on the table and cut the OCR 50bp to 4.75% next week**. But we discussed flipping a coin.
- The economic arguments for a 25bp versus 50bp cut are balanced. Data since the August MPS has confirmed that the economy is very soft, though Q2 GDP was not quite as weak as the RBNZ had forecast. The monthly activity indicators have also broadly rebounded since then (with unders and overs). At the same time, data (particularly the QSBO) has confirmed that disinflation is on track and looks set to remain so, given the spare capacity emerging in the labour market. That likely means that overall, the RBNZ's confidence that they've done enough will have increased since August.
- The RBNZ has clearly pivoted to focus on downside growth risks. Those downside growth risks have actually eased rather than strengthened since August, but on balance it seems likely that the Committee will decide that getting the OCR closer to neutral quickly is a low-risk strategy. The default expectation for November also now logically has to move to another 50bp cut, so we're pencilling that into our forecasts too. But that's a very lightly held view; the data will decide, and the RBNZ is highly likely to reiterate that point.

The view

The market is now all but fully pricing a 50bp cut, and the majority of economists are now predicting it, so it's clearly now the path of least resistance. We'll lay out the arguments, and frankly, you can make up your own mind; we don't think they make for an easy decision.

It's a bit old school, but **reason #1 for a 25bp cut has to be because that's what they laid out in August**, and the recent data hasn't provided much in the way of downside surprises. However, we freely acknowledge that that kind of reasoning has provided bad steers of late. If the Committee thinks the best move is to cut 50bp, it's clear they will not feel constrained in the slightest by what they've said in the past.

While Q3 CPI inflation (a week after the MPS) will be well within the 1-3% band (we and the RBNZ expect 2.3% y/y), the mix is uglier than the headline, with **the RBNZ forecasting non-tradable inflation of 5.1% y/y. Is that a constraint?** Things are looking on track for it to keep falling to where it needs to be (say 3%), but that remains a forecast, not a fact.

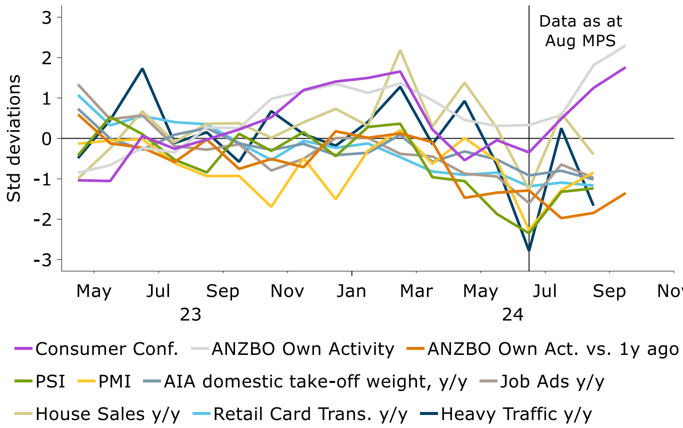
When asked about whether the RBNZ had considered cutting 50bp in August, the Governor replied "yes", and that was of course the headline, but the response is worth quoting in its entirety:

Yes, we always test ourselves hard on a range of what is the decision and then what are the chances. Either way, I have to say the consensus was for 25 basis points. It's because we have a series of further visits between now and the end of the year, October and the November monetary policy statements and we're really keen to see the actual CPI inflation data and things evolve. So going from 5.50 to 5.25 is a strong start, but it's a reasonably low risk start for the committee.

One could read that comment as supporting either a 25bp or 50bp cut. On the one hand, **will the committee still be "really keen to see the actual CPI data" before picking up the pace of cuts?** We see the risks around their Q3 CPI forecast as balanced, but their *certainty* around that forecast will have increased substantially, given they now have two months of selected price index data. That might well be sufficient. On the other hand, **if the Committee really wanted to cut 50bp in August but did feel implicitly constrained by their recent hawkish stance, that's no longer an issue.** A 50bp cut would be easy to deliver, and easy to justify.

The June high-frequency data that the RBNZ had to hand when it made its decision to cut the OCR in August **marked the low point of the high-frequency data 'vibe', rather than the beginning of a downward spiral** (figure 1). Large OCR cuts are typically seen as an "emergency" measure, and there's no emergency currently. But the committee may well not see things that way. The Fed didn't, after all.

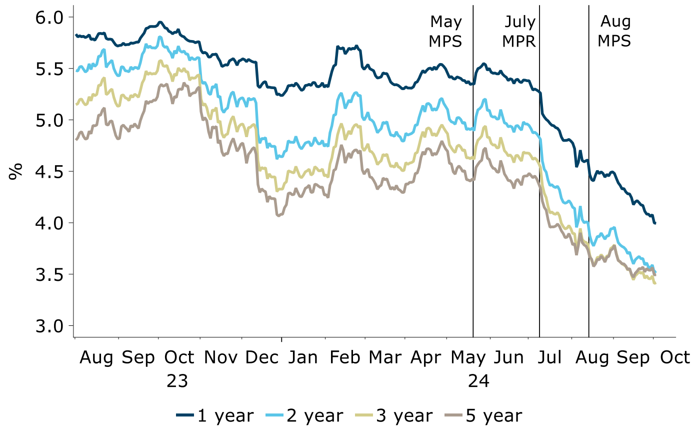
Figure 1. High-frequency activity indicators



Source: Stats NZ, BusinessNZ, AIA, REINZ, Seek NZ, Macrobond, ANZ Research

Since the August MPS, swap yields have fallen a long way, influenced at least as much by US data and the recent 50bp cut by the Federal Reserve as local data (figure 2). You could argue this either way. If the RBNZ does cut by only 25bp, shorter-end swap yields will back up a little, which the Committee may view as undesirable. But probably not much, and in the bigger picture, the yield curve is doing the OCR's work for it. And if the RBNZ cuts 50bp, yields could fall a lot further yet. Would the RBNZ welcome that? Again, it'll come down to the RBNZ's confidence that they've done enough.

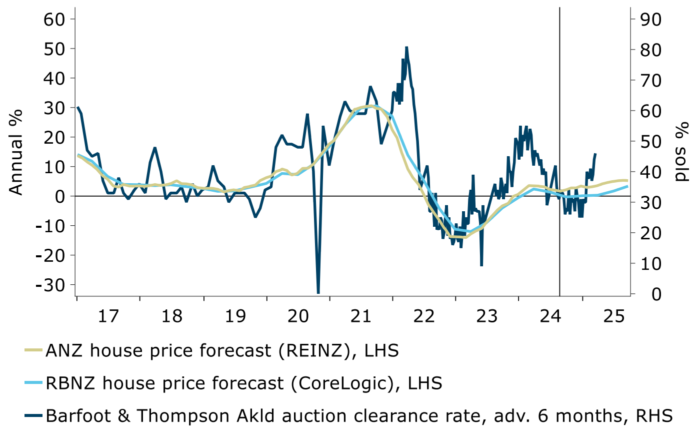
Figure 2. Swap yields



Source: Bloomberg, Macrobond, ANZ Research

Significant mortgage rates falls mean the housing market is perking up rapidly. Exhibit A: the Barfoot and Thompson auction clearance rate, which signals upside risk to the RBNZ's house price forecasts that build in no lift until the second half of next year (figure 3). The RBNZ's model has a clear channel from house prices to consumption, and from there to medium-term inflation. Counter-argument: if you think inflation risks are tilting to undershooting, then this isn't a problem.

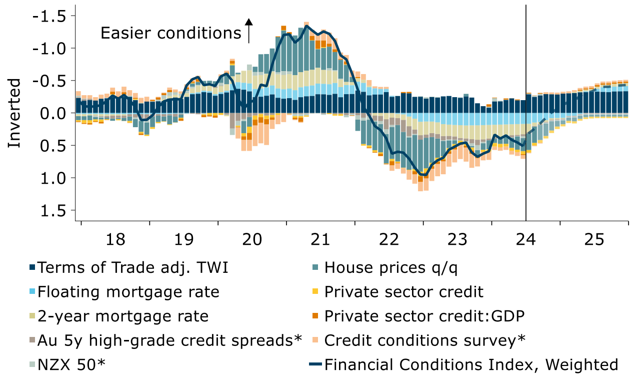
Figure 3. Barfoot & Thompson auction clearance rate and house prices



Source: CoreLogic, REINZ, B&T, interest.co.nz, Macrobond, ANZ Research

Credit conditions continue to ease as a result of CCCFA changes, tax cuts, easing LVR restrictions, falling serviceability test rates and intense competition. That, plus falling mortgage rates and house price falls petering out (and with upside risk emerging) mean that **our financial conditions index is pointing to a V-shaped economic recovery** (figures 4 and 5). Would that be a problem, in the context of this being a deliberate recession? Given the current weakness in activity and clear evidence of spare capacity opening up, it wouldn't necessarily represent a threat to inflation returning sustainably to target.

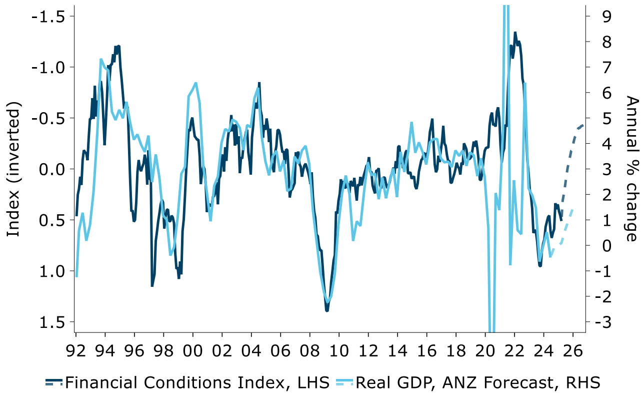
Figure 4. ANZ Financial Conditions Index (FCI)



* Held constant after last observed value

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

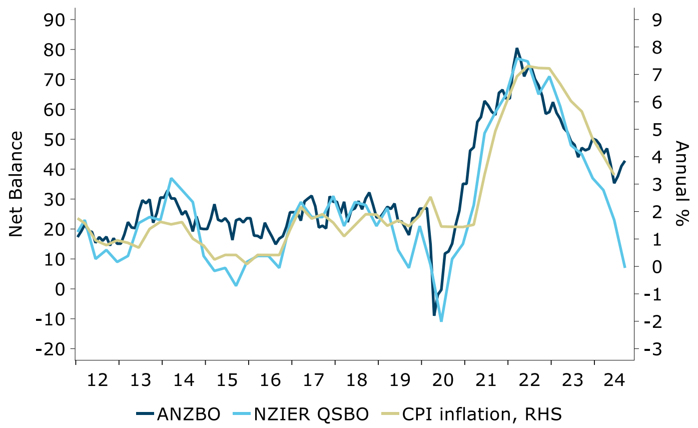
Figure 5. ANZ FCI and GDP



Source: Stats NZ, Macrobond, ANZ Research

What do the direct inflation indicators say? Pricing intentions in the ANZBO survey have been sticky lately, but QSBO pricing intentions have been much more encouraging, dropping right back to pre-COVID levels. ANZBO pricing intentions tend to be higher than QSBO pricing intentions when non-tradable inflation is a lot higher than tradable inflation. Perhaps the ANZBO survey sample has more firms that are domestically focused. Whatever the reason, there have been times in the past when the QSBO measure has better captured disinflation that's occurring on the tradables side of the CPI equation (see 2015-16), and this could well be one of those times (figure 6). That said, non-tradable inflation is the sticky part of inflation and so generally matters more when considering the medium-term inflation outlook.

Figure 6. ANZBO and QSBO pricing intentions

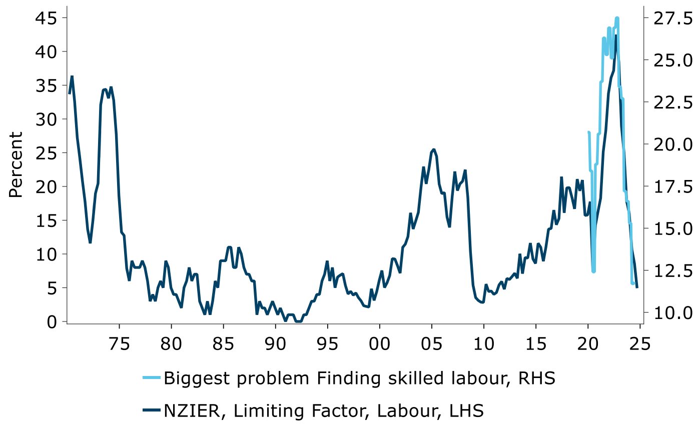


Source: NZIER, Stats NZ, Macrobond, ANZ Research

While quarterly GDP 'growth' was 0.3%pt stronger than the RBNZ expected in Q2, at -0.2% q/q it was indisputably weak, particularly in per capita terms. Experienced activity measures in both ANZBO and the NZIER's QSBO suggest Q3 will bring more of the same (though importantly, that's as the RBNZ is forecasting; this isn't a surprise).

Consistent with this soft activity, capacity indicators, especially for the labour market, continue to soften in both business surveys (figure 7). Unemployment is clearly going to continue rising. Firms are expecting to offer wage increases of well under 3% in the next 12 months. Wages are a lagging indicator, certainly, but they are nonetheless very important for the non-tradable inflation picture, and here and now it's hard to see any upward pressure emerging any time soon.

Figure 7. QSBO Labour as limiting factor, ANZBO Finding skilled labour as a problem



Source: NZIER, Stats NZ, Macrobond, ANZ Research

Pulling it all together

Weighing it up, and taking risks on both sides into account… it's clear as mud. We are much less convinced than the market that a 50bp cut is a done deal, but we are now over the line.

We've laid out the arguments and the data here, but it all boils down to one thing: will the RBNZ now be more certain than they were in August that the job is done; that inflation will not only fall back into the band (a given, and imminent) but stay there? The economy is not as weak as they thought, with the risks tilted towards a faster rebound than they expected in August. On the other hand, they can have more confidence about the current degree of spare capacity in the economy and near-term disinflation, and that counts for a lot.

The traditional way of predicting RBNZ's policy decisions – seeing what they said last time and looking at whether the data justifies a deviation from that plan – clearly argues for a 25bp cut. But stepping right back and looking at the big picture, if you ask the question, "is it reasonable for the RBNZ to be confident that they've done enough?" then it would be very easy to justify a 50bp cut. The market has made its mind up firmly in favour of 50bp; we view it as a much closer-run thing than that. We'll find out next Wednesday what the Committee thinks.

Markets

With a 50bp cut now the likeliest outcome next week and (conditionally) in November, we see scope for short-end rates to continue edging lower, both into next week's decision, and on confirmation of the faster pace of easing. With markets now pricing in 46bps for next week and a further 49bps priced in for the November meeting (that is, markets are wagering on 95bp of cuts over the two meetings), it's less about the decision itself surprising markets, and more about them likely extrapolating what's delivered and moving to price in yet more easing going forward. Our sense is that markets will quickly move to adopt 50bp cuts as their base case for November and February, and likely start pricing in some chance of 75bp cuts at both meetings to account for the unusually long three-month gap between the November and February meetings.

That front-running tendency of markets was one of the reasons why until now, we have favoured a 25bp cut, because it has brought with it much easier financial conditions than the current 5.25% OCR would suggest. But given the state of play, we now think the Monetary Policy Committee will simply take the path of least resistance, and take what’s on offer seeing as they have already flagged a further 225bp of cuts. If we do only see a 25bp cut (a risk the market is underestimating, in our view), the market would need to re-price. However, we suspect any upward movement would be limited (and limited mostly to the very short end), as markets take the view that more easing is ultimately coming, and soon. This early on in the easing cycle, the long end is likely to follow the short end on the day (ie it’s probably too soon for long-end yields to rise as a recovery vibe kicks in). But bond markets need to get through US non-farm payroll data due out in the early hours of Saturday market first!

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