ANZ Research

Preview: RBNZ Monetary Policy Statement

7 August 2024

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Contact

Sharon Zollner or David Croy for more details.

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Cooler heads

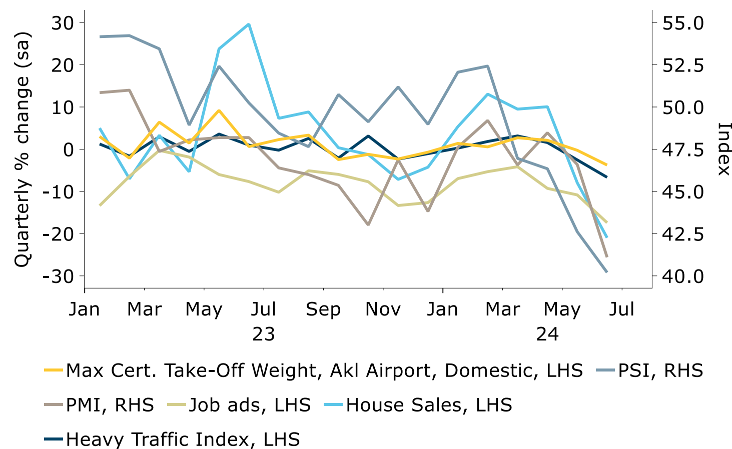
- **We expect the RBNZ to leave the OCR at 5.50% next week, and to signal a potential cut in the OCR later this year**, with the Record of Meeting likely to reveal that an OCR cut was considered at this meeting.
- The data since May, and particularly since the July Monetary Policy Review, points to a clearly slowing economy, and solid disinflation progress. That justifies cutting the OCR far earlier than August 2025, as was signalled in the previous Monetary Policy Statement.
- We certainly wouldn't rule out a cut next week, as risks have clearly tilted towards more economic weakness than is necessary to beat inflation. But there's no smoking gun in the top-tier data, and our base case is that the Monetary Policy Committee will conclude that waiting for more evidence of the state of play is justified – and relatively low cost, given monetary conditions have already eased substantially.
- We continue to expect the first cut in November, with risks still tilted to it coming in October if the recent weakness in high-frequency activity data persists.

Here, we lay out the case for and against a cut next week. For our part, we find the case for holding the OCR much more convincing.

Why cut?

Since the May MPS, the high-frequency activity data has taken a clear turn south in a broad-based fashion (figure 1). It isn't just forward-looking sentiment data either – transport data like heavy traffic and domestic plane loadings have also slumped.

Figure 1. Selected recent high-frequency activity data

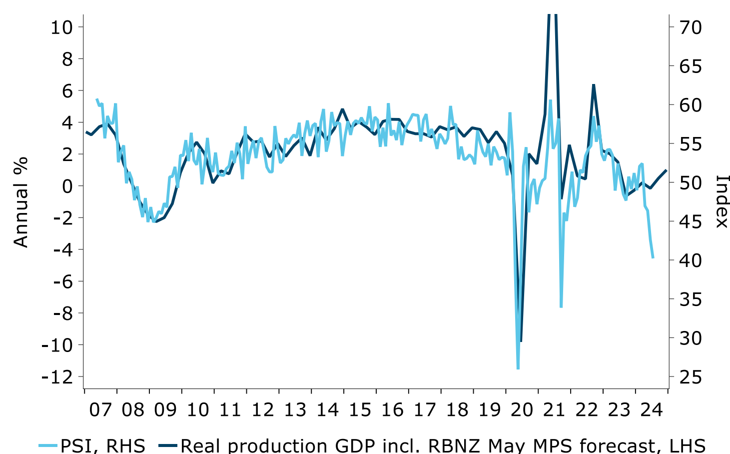


Source: Stats NZ, BusinessNZ, BNZ, REINZ, SEEK, AIA, Macrobond, ANZ Research

Indeed, if you take the June Performance of Services data in figure 2 (over) at face value, it's 'case closed'. But would banking *all* of this sudden weakness as pure signal pass the sniff test? For sure, the cumulative

impacts of the RBNZ's tightening are working their way through the economy, painfully. But there's been no sudden income or confidence shock that would suggest the economy should be collapsing even more dramatically than it did in response to the Global Financial Crisis. Some of this seems likely to be survey noise and volatility.

Figure 2. RBNZ May GDP forecast vs Performance of Services Index



Source: BNZ, BusinessNZ, RBNZ, Macrobond, ANZ Research

But data volatility aside, it's clear that inflation expectations, pricing intentions, wage-setting expectations and measures of labour market slack are all doing what they need to do. The RBNZ shouldn't and probably won't wait until the 2% inflation target has actually been reached before cutting, given the long lags with which monetary policy affects the economy. The Committee will cut when they are confident that the combination of disinflation progress made and downward momentum in inflation pressures together mean they have a sufficient buffer in place to absorb any inflationary surprises that may come along before inflation is sustainably back at target. At that point the Committee will switch its focus from saving the economy from inflation to saving it from unnecessary damage. We'd put perhaps 10-15% odds on that switch occurring at this meeting.

Why hold?

- First up, the elephant in the room: **non-tradable inflation is still 5.4% y/y.** When the RBNZ called a halt to hikes in May 2023, they expected it to be at 4.1% by now. And note that at that time, they foresaw the first cut coming around the end of this year. Things are going right, absolutely, but they could still go wrong, ie inflation could take longer to come down than expected for a range of reasons.

- **Starting point surprises:** In the last MPS, the RBNZ wasn't anticipating cutting the OCR until August 2025. Ostensibly, therefore, it would take enormous surprises in the top-tier data to justify bringing the first cut forward by a full 12 months. And our ready reckoner chart pack shows that simply hasn't happened. We've had only minor news.

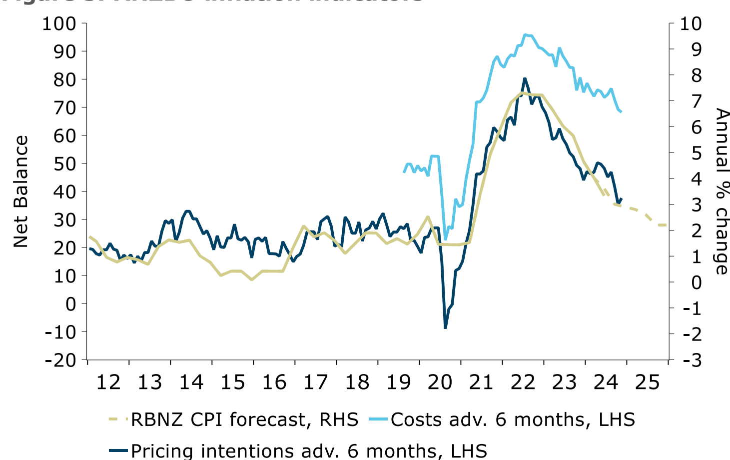
  - Global prices and tradable inflation were a bit lower than the RBNZ anticipated in Q2.

  - Non-tradable inflation in Q2 was 0.1%pt higher than the RBNZ expected, but there was a one-off technical adjustment to the measurement of road user charges of about this magnitude.

  - The exchange rate has slipped a little but for good reasons (China's growth outlook), so we'll call that neither here nor there.

- Private consumption was stronger in Q1 than the RBNZ expected, but Stats NZ warned that the data might not be reliable. Meanwhile, retail indicators are dire, though consumer confidence picked up a little last month.
- Headline Q1 GDP was much as the RBNZ expected, but they'll likely be revising down their Q2 GDP pick based on the high-frequency data discussed on page 1. But whether they'll be making substantive revisions to their medium-term forecasts of activity and inflation pressure is more of a judgment call. In our view, the data since May warrants a small downgrade, but not a wholesale rethink. That said, the RBNZ's *confidence* in their forecast of inflation falling sustainably back to target should be much greater, which is why we've brought our forecast of cuts forward to this year.

Figure 3. ANZBO inflation indicators



Source: RBNZ, Macrobond, ANZ Research

- Q2 labour market data out today was stronger than the RBNZ expected, on balance. At 4.6%, unemployment was on their expectation, but the underlying details showed stronger employment (+0.4% q/q vs their forecast of +0.1% q/q) offset by higher labour force participation. On the other hand, youth unemployment jumped, but overall, the data confirms the labour market is loosening, but not faster than the RBNZ expected.

Putting all that into ready-reckoner analysis can be a useful sense check, but it's always worth bearing in mind three qualifications:

1) it takes previous forecasts as a starting point, but changes in assumptions can make them much less relevant.
2) It's subjective: what weight is effectively put on different factors?
3) The vibe of the OCR forecast and the tone of the press conference can diverge wildly at times.

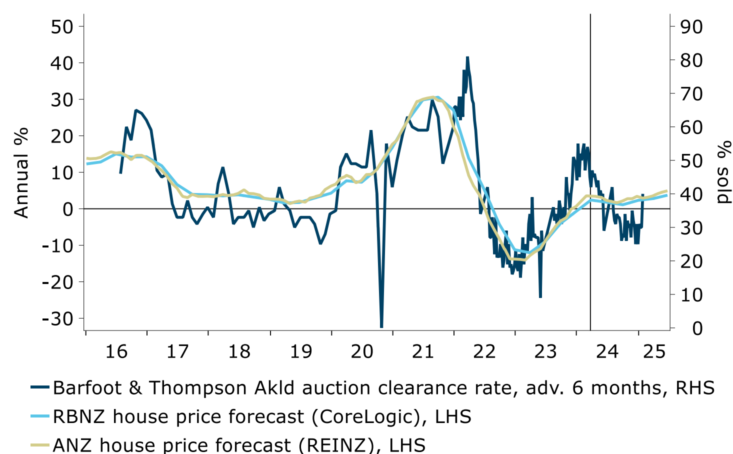
But for what it's worth, our ready reckoner, taking into account all the above news and adding a solid dose of judgment for downside risks to boot, suggests a peak in the OCR track that's around 50bp lower than the May MPS track, which peaked at 5.65%. At a *stretch* that's a track implying about 50:50 odds of an OCR cut this year.

Arguably, this is one of those times when the previous published forecasts are less likely to be a reliable starting point. Some pessimistic assumptions made in May might be partially walked back (though that is far from a given) and some recent RBNZ research could support a more dovish take on things.

But putting aside the lack of a smoking gun in the tier-one starting point data, there are other reasons to hold off from cutting the OCR immediately.

- **Strategy and optionality**: Once you start cutting, the default question becomes how much you're cutting at the next meeting. A 'dovish hold', on the other hand, leaves open all options from a 50bp 'catch-up' cut in October to holding at 5.5% for months yet, depending on how the data evolve.
- **Will the June slump in the data stick?** It was remarkably broad based. But some of it could nonetheless be noise. Sentiment may well have taken a temporary hit from the hawkish May Monetary Policy Statement with its triple header of bad news: lower growth, higher inflation, and high interest rates for longer. Expectations of rate cuts this year are now almost universal – what's that worth in terms of firms' and households' decision-making? Times are clearly very tough. But one more month of data would give a better sense of whether things are going down the gurgler or bouncing around the bottom. Both business and consumer sentiment lifted in July, and tax cuts have just arrived.
- **How will the housing market respond to the fall in mortgage rates?** The RBNZ is likely to be revising its house price forecasts down next week. But that doesn't mean it won't still bear in mind the potential awkward scenario where OCR cuts see housing rebound enthusiastically and threaten disinflation momentum. *Very* early data showed a sharp jump in the Barfoot and Thompson auction clearance rate – the most leading indicator for housing market momentum there is. Of course, like every leading indicator it can give the occasional false steer, and this is literally one week of data in a volatile data series.

Figure 4. Barfoot and Thompson auction clearance rate and house prices

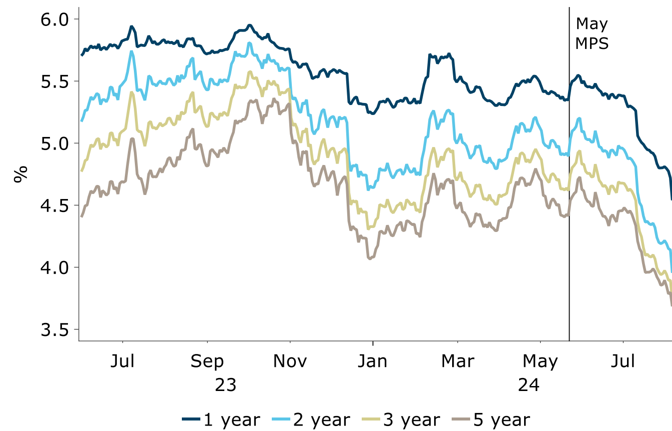


Source: CoreLogic, REINZ, B&T, interest.co.nz, Macrobond, ANZ Research

- **Monetary conditions are already easing, so what's the panic?** The move down in wholesale interest rates has been absolutely massive since May (figure 5), putting fixed and even floating mortgage rates under downward pressure. It's possible the RBNZ will push back. That's not our expectation, given the vibe of the recent data flow, but it would make sense to sit back, and observe the response. The market

is not likely to be swayed (for long, anyway) from its dovish views by anything the RBNZ says or does next week if the data continues to come in so soft, so any tightening in monetary conditions engendered by a 'hawkish' MPS relative to market expectations would be short-lived if the incoming data tells a different story.

Figure 5. Swap yields



Source: Bloomberg, Macrobond, ANZ Research

- **Credit conditions are easing substantially** as a result of CCCFA changes, tax cuts, easing LVR restrictions and intense competition in a slow housing market.

Putting it together

This is not going to be an easy set of forecasts to put together, given the current situation of heightened uncertainty. And we wouldn't be surprised in the least if the Summary Record of Meeting were to indicate that cutting the OCR was discussed. Given the long lags with which monetary policy affects the economy, the classic dilemma of making timely decisions versus being sure will likely get a lot of airtime in the debate. The market has made its judgment – that the inflation dragon is long dead and starting to smell – but it's the RBNZ's job to be a little more paranoid than everyone else on that score.

For the RBNZ to ease next week, we'd be looking at one of the most dramatic revisions to RBNZ OCR forecasts in history, when so far, the dovish data surprises have been second tier, albeit broad based. Even allowing quite a bit of judgement in response to the weak vibe of the forward-looking data (in terms of what this means for spare capacity going forward), our ready reckoner struggles to lower the peak of the May MPS OCR track by more than 50bps over the projection. Depending on phasing, this could signal a solid chance of a cut by the end of the year, while stopping well short of a promise.

Such a track would leave the market to watch the data and adjust cut odds in real time accordingly. Seems to us that holding the OCR and publishing such an OCR track would be a sensible middle ground that balances the potential regrets on each side. Holding a little too long can be easily and rapidly fixed – indeed the market will do (is doing) the easing work for the RBNZ. And the next OCR Review is just six weeks later. On the other hand, betting the house on the down-the-gurgler scenario would put the Committee in a very awkward spot should data subsequently start to surprise on the upside. That's a possibility the market has completely discounted but one that the RBNZ is unlikely to write off.

Markets

We suspect markets will be in for a reasonable degree of disappointment next week, especially if we go into the MPS with non-trivial odds of an August cut still priced in (as is still the case even after the release of Q2 labour market data today), and the RBNZ holds the OCR at 5.5%. That data didn't provide the "smoking gun" some in markets were hoping for, and although we have seen market implied odds of an August cut fall from around 90% to around 55%, that still leaves plenty of room for disappointment on the day, unless we see a dramatic shift between now and the MPS next Wednesday. The only data out between now and then is the RBNZ inflation expectations survey tomorrow and their household survey next Tuesday, both second tier. That suggests the vibe from offshore could have as much influence on market pricing over the next week as anything else.

As we go to print, we note that markets are still pricing in around 89bp of cuts by November, and 222bp of cuts by next November. We estimate that the RBNZ would need to lower their Q3 2024 OCR projection (which is a quarterly average) by 18bp and their Q3 2025 OCR projection by a whopping 178bp in order to validate that expectation.

The latter in particular is a huge shift, and even if we discount any mismatch (to acknowledging the tendency of markets to front-run the RBNZ), there's still plenty of room for disappointment. As we noted earlier, even at a *stretch* we're struggling to contemplate a track that implies more than 50:50 odds of an OCR cut this year (assuming the RBNZ doesn't make wholesale and extreme judgements around their medium-term outlook). That leaves us a bit wary of short-end rates here, even with the 2yr swap back at 4.11%, versus a low of 3.955% at the height of this week's market volatility.

The prospect of an upward correction in short-end rates also leaves us wary of the long end, but the big driver there is what happens to global rates, blunting the impact somewhat. A re-rating of market expectations for the OCR also speaks to upside risks for the Kiwi, global volatility notwithstanding.

Contact us

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Sharon Zollner
Chief Economist

Follow Sharon on X
@sharon_zollner

Telephone: +64 9 357 4094
Email: sharon.zollner@anz.com

General enquiries:
research@anz.com

Follow ANZ Research
@ANZ_Research (global)

David Croy
Senior Strategist

Market developments, interest rates, FX, unconventional monetary policy, liaison with market participants.

Telephone: +64 4 576 1022
Email: david.croy@anz.com

Susan Kilsby
Agricultural Economist

Primary industry developments and outlook, structural change and regulation, liaison with industry.

Telephone: +64 21 633 469
Email: susan.kilsby@anz.com

Miles Workman
Senior Economist

Macroeconomic forecast co-ordinator, economic developments, GDP and activity dynamics, fiscal and monetary policy.

Telephone: +64 21 661 792
Email: miles.workman@anz.com

Henry Russell
Economist

Macroeconomic forecasting, economic developments, labour market dynamics, inflation and monetary policy.

Telephone: +64 21 629 553
Email: henry.russell@anz.com

Natalie Denne
PA / Desktop Publisher

Business management, general enquiries, mailing lists, publications, chief economist's diary.

Telephone: +64 21 253 6808
Email: natalie.denne@anz.com

Kyle Uerata
Economic Statistician

Economic statistics, ANZ proprietary data (including ANZ Business Outlook), data capability and infrastructure.

Telephone: +64 21 633 894
Email: kyle.uerata@anz.com

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