ANZ Research

RBNZ Monetary Policy Statement Review

22 May 2024

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Contact

Sharon Zollner or David Croy for more details.

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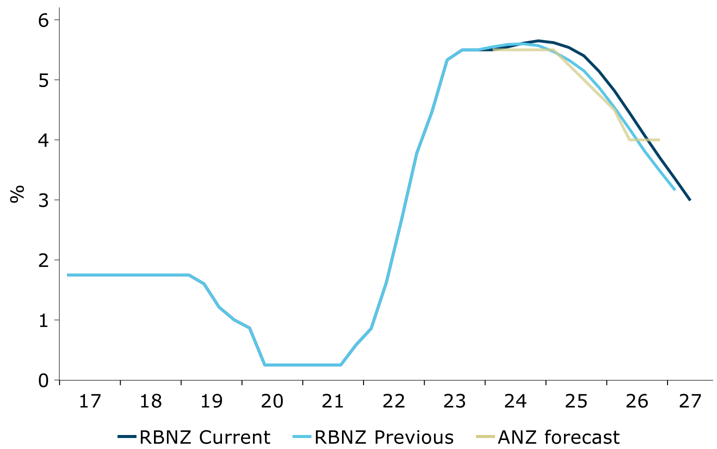
Summary

- As expected, the RBNZ left the Official Cash Rate (OCR) unchanged at 5.50% today. However, in a shock to markets, the forecast peak OCR was raised from 5.60% to 5.65%, and the Summary Record of Meeting noted that a hike was discussed (though in the end a hold was a consensus decision). Cuts are pencilled in for August next year, 3-4 months later than in the February MPS.
- There was considerable uncertainty today about how the RBNZ would weigh up soft economic data that is clearing cooling (if not congealing) with non-tradable inflation data that has persistently declined more slowly than the RBNZ anticipated – with the biggest miss of all in Q1.
- Soft data (not least our Business Outlook survey) suggests progress on getting domestic inflation down is about to accelerate meaningfully. However, the RBNZ is going to believe that when it sees it, as they are concerned that the slow progress thus far means that capacity pressures in the economy may have been greater than thought. The RBNZ's inflation forecasts have been revised up significantly, with inflation only returning to 2% in mid-2026, six months later than previously.
- Our OCR forecast remains unchanged, with the first cut in May 2025. Despite the hawkish MPS today, we still see the risks tilted towards earlier rather than later.

In brief

As universally expected, the RBNZ today left the Official Cash Rate (OCR) unchanged at 5.50%. But under the hood, there was plenty to digest. The main interest for the market was the forecast OCR track, as well as the general tone of the Policy Assessment. Both were more hawkish than expected, and swap rates and the currency both jumped accordingly.

Figure 1. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

Key quotes:

- **OCR decision:** "In the context of persistent domestic inflation, weaker productivity growth, and uncertainty regarding the pace of normalisation in wage and price-setting behaviour, the Committee discussed the possibility of increasing the OCR at this meeting. … The Committee reached a consensus to keep the Official Cash Rate at 5.50 percent."
- **OCR outlook:** "The Committee agreed that interest rates need to remain at a restrictive level for a sustained period to ensure annual headline CPI inflation returns to the 1 to 3 percent target range. … the Committee also agreed that interest rates may have to remain at a restrictive level for longer than anticipated in the February Monetary Policy Statement to ensure the inflation target is met."
- **Policy transmission:** "The Committee noted that the estimate of the long-run nominal neutral OCR used in the projections has been increased by 25 basis points to 2.75 percent, consistent with the Reserve Bank's indicator suite. Members agreed that the current level of the OCR remains contractionary."
- **Labour market:** "Members noted that labour market pressures are easing and that businesses are reporting it is much easier to find workers. Members noted that domestic labour market conditions could deteriorate more quickly than anticipated, particularly if firms reduce their labour force rapidly in response to weak demand."
- **Domestic activity:** "A prolonged period of restrictive interest rates is reducing household spending and residential and business investment. Capacity pressures in the New Zealand economy have eased significantly over the past year and aggregate demand is now broadly in line with the supply capacity of the economy."
- **Inflation outlook:** "The Committee assessed that, while the near-term balance of risks around inflation are skewed to the upside, there is more confidence that inflation will decline to within the target range over the medium term."
- **Fiscal policy:** "The Committee also discussed the implications of the publicly announced aspects of Budget 2024 for the economic outlook. If the decline in government revenue due to tax cuts is fully offset by lower government expenditure, then the net impact on aggregate spending is broadly neutral over an extended horizon."

The RBNZ remains firmly in data-watch mode, but with data deteriorating, the market is likely to continue to continue to price cuts well in advance of the RBNZ's own forecast, which now implies the first cut in August next year.

Our OCR forecast remains unchanged, with the first cut in May 2025. Despite the hawkish MPS today, we still see the risks tilted towards cuts coming earlier rather than later, given the increasingly broad-based weakness in the economy.

RBNZ forecasts in brief

As we expected, the RBNZ revised down their GDP growth forecasts a little. However, their estimate of the speed limit of the economy (potential output) was also revised down, offsetting the impact on their output gap forecast (ie how much disinflationary spare capacity there is – and will be – in the economy). Their output gap forecast is a little higher in the near term (ie less disinflationary pressure), but lower from mid-2025.

The inflation forecasts have been revised higher in the near term, pushing out when annual inflation is expected to be in the 1-3% target band by one quarter (now Q4 2023), and getting all the way back to 2% now takes six months longer. The key non-tradable part of inflation is higher, baking in the meaningfully higher starting point. Labour market forecasts are similar to the February MPS, with the unemployment rate expected to peak at 5.1% in 2025, but stay elevated a little longer.

See page 8 for forecast comparisons against the February MPS and our own forecasts.

Risks

As always, the RBNZ were at pains to outline risks to the outlook on both sides. It was a familiar list.

Risks around tradable inflation are considered "balanced" but the Committee acknowledged how this particular component can be volatile – they're not wrong about that! But the Committee also noted that developments in the Middle East have not resulted in a large increase in oil prices, and goods inflation continues to decline across advanced economies.

Regarding non-tradable inflation, the Committee see "significant upside risk", hinting that inflation and wage expectations, and slower potential output growth than currently assumed are all potential catalysts for non-tradable inflation being slower to fall than expected.

Our take

The RBNZ today sent a stern message to a market that has been keen to price cuts already this year. Today's Statement is not going to stop the market from making up its own mind. Offshore participants in particular are focused very much on the fact that headline inflation is forecast to be back in the band by the end of the year. However, the RBNZ doesn't just want to see inflation back in the band – they want to be confident it'll stay there, which requires a decent fall in non-tradable inflation.

Our recently updated forecasts for the big picture are similar to the RBNZ's: the economy is slowing, the export outlook is challenged, and unemployment is set to rise. When that will provide the RBNZ sufficient confidence in the inflation outlook to ease the OCR will remain a point of vigorous contention. We're optimistic that that will be earlier than the RBNZ currently expects.

Financial markets

Interest rates and the NZD moved immediately higher in response to today's MPS. That was the logical reaction given our sense that the two things that markets were looking for – a truncation in the track to 5.50% over 2024 and a lower track over 2025 – didn't eventuate. Instead, the RBNZ lifted the track by 5bp, delayed the peak by one quarter, and perhaps most importantly, delayed the timing of the first dip in the track below the current OCR by two quarters.

Looking beyond the immediate market reaction, we're conscious that markets are not suddenly going to stop gunning for cuts just because the RBNZ has delivered a hawkish tilt. Markets know that the RBNZ isn't likely to be willing to signal a pivot until the last minute, but even so, today's projections will test the resolve of those calling for imminent cuts. And given how expensive it is on a carry basis to be long/invested, short-end rates are likely to drift a little higher over coming days.

However, we think the RBNZ's hawkish tilt will ultimately be well received by long-end bond investors, from the perspective that it is better to have a central bank that is resolute and determined than one prepared to tolerate higher inflation. For the Kiwi, the RBNZ's new tone underscores our expectation of mild strength over the remainder of 2024.

OCR 5.50% – Official Cash Rate to remain restrictive

The Monetary Policy Committee today agreed to keep the Official Cash Rate at 5.50 percent.

Restrictive monetary policy has reduced capacity pressures in the New Zealand economy and lowered consumer price inflation. Annual consumer price inflation is expected to return to within the Committee's 1 to 3 percent target range by the end of 2024.

The welcome decline in inflation in part reflects lower inflation for goods and services imported into New Zealand. Globally, consumer price inflation has declined from 30-year highs in many advanced economies. However, services inflation is receding slowly, and expected policy interest rate cuts continue to be delayed.

In New Zealand, pressures in the labour market have eased. Businesses are employing more cautiously in line with weak economic activity, while the number of people available to work has increased due to recent high net inward migration. Wage growth and domestic spending are easing to levels more consistent with the Committee's inflation target.

While weaker capacity pressures and an easing labour market are reducing domestic inflation, this decline is tempered by sectors of the economy that are less sensitive to interest rates. These near-term factors include, for example, higher dwelling rents, insurance costs, council rates, and other domestic services price inflation. A slow decline in domestic inflation poses a risk to inflation expectations.

Our economic projections include only officially available information on the Government's fiscal intentions to date, which includes the most recent fiscal update and 'mini budget'. The signalled lower government spending is currently and expected to continue contributing to weaker aggregate demand. Any impact of potential changes in the forthcoming Budget to government spending, or private spending due to tax cuts, remain to be assessed.

Annual consumer price inflation remains above the Committee's 1 to 3 percent target band, and components of domestic services inflation persist. The Committee agreed that monetary policy needs to remain restrictive to ensure inflation returns to target within a reasonable timeframe.

Summary Record of Meeting – May 2024

The Monetary Policy Committee discussed recent developments in the domestic and global economies and the implications for monetary policy in New Zealand. Restrictive monetary policy is contributing to an easing in capacity pressures. Headline inflation, core inflation, and most measures of inflation expectations are continuing to decline. However, domestic inflation has fallen more slowly than expected and headline Consumers Price Index (CPI) inflation remains above the Committee's target band. Members of the Committee agreed that monetary policy needs to remain restrictive to ensure inflation returns to target within the forecast timeframe.

Aggregate global economic growth was below trend last year and is expected to slow further in 2024. However, the economic outlook varies among New Zealand's trading partners. In the United States, monetary policy has contributed to an easing in capacity pressures and inflation, but economic growth remains stronger than in many other developed economies. In most other advanced economies, domestic demand remains weak. In China, economic activity strengthened in early 2024, although continued weakness in the property sector remains a significant downside risk to growth.

The Committee noted that headline and core inflation have continued to decline in many advanced economies. To date, the decline in headline inflation internationally has been due in large part to lower goods, energy, and food price inflation. Inflation in services has declined, but by less than anticipated at the start of the year. Nevertheless, inflation in New Zealand's trading partners is expected to continue to decline.

In discussing global financial conditions, the Committee noted that persistent inflation in some of New Zealand's key trading partners has led to fewer policy interest rate cuts being priced in by financial markets. Higher long-term wholesale interest rates globally have supported wholesale interest rates in New Zealand. Participants in global financial markets continue to exhibit confidence in the corporate earnings outlook, as reflected in equity prices and credit spreads.

The Committee discussed recent developments in financial conditions in New Zealand. Overall, credit growth remains weak. The average interest rate across the stock of mortgage borrowers continues to increase and is near its projected peak of 6.5 percent. Bank funding costs are expected to increase over the forecast period as funding sources normalise, with a reversion to higher cost wholesale and term deposit funding. Higher funding costs in turn are expected to maintain upward pressure on lending rates over the medium term.

The Committee received an update on the continued sales of New Zealand Government Bonds held in the Large Scale Asset Purchase Programme portfolio. Despite the high level of bond issuance over recent years, measures of secondary market liquidity generally remain in line with historical averages and demand for New Zealand Government Bonds in the primary market remains strong.

The Committee discussed recent domestic economic developments. A prolonged period of restrictive interest rates is reducing household spending and residential and business investment. Capacity pressures in the New Zealand economy have eased significantly over the past year and aggregate demand is now broadly in line with the supply capacity of the economy.

Members noted that labour market pressures are easing and that businesses are reporting it is much easier to find workers. Labour supply has continued to increase, due to strong population growth, and wage growth has continued to decline but remains elevated.

The Committee discussed New Zealand's current low rate of productivity growth and its implications for lower potential output growth and higher capacity pressures. The Committee noted that the revised smaller negative output gap in the published projections is more consistent with recent persistence in domestic inflation pressure.

The Committee discussed possible causes of the current low productivity rate and whether they were temporary or more persistent. For example, some labour hoarding by firms is likely to have occurred in response to the previous acute labour shortages once New Zealand's borders were reopened. This could prove to be temporary.

The Committee noted that the forecast for government expenditure in the projections is based on Treasury's Half Year Economic and Fiscal Update (HYEFU) 2023, adjusted to reflect the December 2023 quarter GDP data. Based on this information, the share of government expenditure in the economy is projected to decline. However, due to weaker potential output growth, government expenditure is higher as a proportion of potential output than projected in the February Statement and hence less disinflationary.

The Committee also discussed the implications of the publicly announced aspects of Budget 2024 for the economic outlook. If the decline in government revenue due to tax cuts is fully offset by lower government expenditure, then the net impact on aggregate spending is broadly neutral over an extended horizon.

However, the Committee discussed how differences in the timing between potential lower government spending and lower tax rates are relevant to monetary policy. The Committee noted that the signalled lower government spending is currently and expected to continue contributing to weaker aggregate demand. However, any likely changes to government spending or private spending due to proposed tax cuts are not in the May Monetary Policy Statement projections. This timing difference poses an upside risk to the forecast of aggregate demand, the relevance of which for monetary policy will be clearer over coming quarters.

The Committee noted that the estimate of the long-run nominal neutral OCR used in the projections has been increased by 25 basis points to 2.75 percent, consistent with the Reserve Bank's indicator suite. The long-run nominal neutral rate affects the central economic projection but has a larger impact in the latter part of the forecast horizon and beyond. Members agreed that the current level of the OCR remains contractionary.

The Committee discussed recent inflation outturns. An easing in capacity pressures in the New Zealand economy and falling inflation expectations over the past 12 months are working to bring domestic inflation down. Annual CPI inflation fell to 4.0 percent in the March 2024 quarter but remains above the Committee's 1 to 3 percent target band.

Both tradable and non-tradables inflation contributed to the decline in headline CPI inflation. However, annual non-tradables inflation declined only slightly to 5.8 percent, which was higher than the 5.3 percent forecast. This upside surprise was broad-based across non-tradables inflation components.

The Committee discussed the outlook for non-tradables inflation. So far, the decline in non-tradables inflation has primarily been due to housing and construction costs, which are typically more sensitive to monetary policy. Further near-term disinflation in non-tradables is likely to be due to falling inflation for some market services, as labour market conditions continue to soften. However, this is expected to be tempered by some relative prices increases, such as for insurance, local authority rates, and dwelling rents.

Members discussed risks to the inflation outlook. The Committee agreed that risks to tradable inflation were balanced but noted that price changes may continue to be volatile. Risks remain to near-term inflation outcomes given ongoing trade disruptions. To date, developments in the Middle East have not resulted in a large increase in oil prices, and goods inflation continues to decline across advanced economies.

Members agreed that persistence in non-tradable inflation remains a significant upside risk. The influence of recent inflation outcomes on setting future inflation expectations is critical to price setting, wage expectations, and the stance of monetary policy. In addition, slower potential output growth than currently assumed would reduce the pace at which spending can grow without putting upward pressure on inflation. Monetary policy may need to tighten and/or remain restrictive for longer if wage and price setters do not align with weaker productivity growth rates.

Members discussed downside risks to the projections. In China, strengthening manufacturing capacity, alongside subdued domestic demand, could lead to a sharper decline in New Zealand import prices than currently assumed. Some members also noted the risk of a decline in global equity prices, particularly in the US. This risk arises from elevated pricing based on expectations of a near-term easing in US monetary policy, ongoing strong earnings growth, and a low-risk premium. Members noted that domestic labour market conditions could deteriorate more quickly than anticipated, particularly if firms reduce their labour force rapidly in response to weak demand.

In the context of persistent domestic inflation, weaker productivity growth, and uncertainty regarding the pace of normalisation in wage and price-setting behaviour, the Committee discussed the possibility of increasing the OCR at this meeting. The Committee assessed that, while the near-term balance of risks around inflation are skewed to the upside, there is more confidence that inflation will decline to within the target range over the medium term. However, the Committee also agreed that interest rates may have to remain at a restrictive level for longer than anticipated in the February Monetary Policy Statement to ensure the inflation target is met.

The Committee discussed the reasons why inflation is outside of the target range and the expected time for inflation to return to target. The Committee noted that the high inflation experienced both domestically and internationally over recent years reflected the significant disruption to global supply, production, and potential output stemming from the pandemic; the impact on demand of the global easing in monetary policy and the rise in fiscal spending during the pandemic; an increase in commodity prices and shipping costs resulting from war and geopolitical tension; severe weather impacts on local food prices; and the persistence of domestic inflation in part reflecting low productivity.

The Committee noted that annual headline CPI inflation was expected to return to the target band in the December quarter of this year. The Committee agreed that in the current circumstances, there is no material trade-off between meeting their inflation objectives and maintaining the stability of the financial system. The Committee noted that borrowers have faced a significant increase in interest costs, but banks are well placed to support their customers through this difficult period. Restrictive monetary policy settings are necessary to reduce demand in the economy, while avoiding unnecessary instability in output, employment, interest rates and the exchange rate.

In discussing the appropriate stance of monetary policy, members agreed they remain confident that monetary policy is restricting demand. A further decline in capacity pressure is expected, supporting a continued decline in inflation. The Committee agreed that interest rates need to remain at a restrictive level for a sustained period to ensure annual headline CPI inflation returns to the 1 to 3 percent target range.

On Wednesday 22 May, the Committee reached a consensus to keep the Official Cash Rate at 5.50 percent.

Attendees:

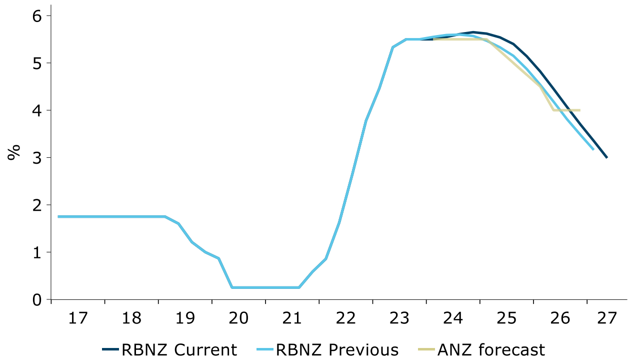
MPC members: Adrian Orr (Chair), Bob Buckle, Carl Hansen, Caroline Saunders, Christian Hawkesby, Karen Silk, Paul Conway

Treasury Observer: Dominick Stephens

MPC Secretary: Elliot Jones

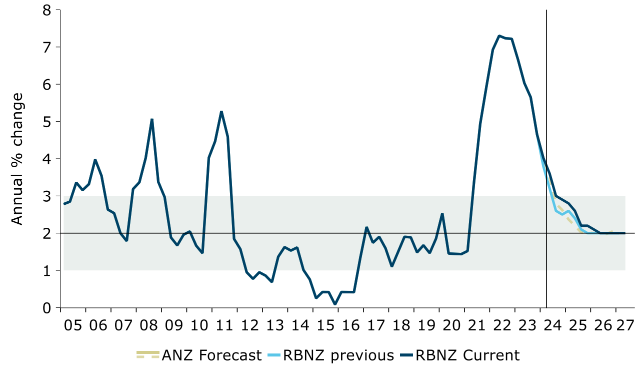
Key forecasts: Activity downgraded, inflation upgraded

The OCR peak is 5bp higher than previously, but occurs one quarter later



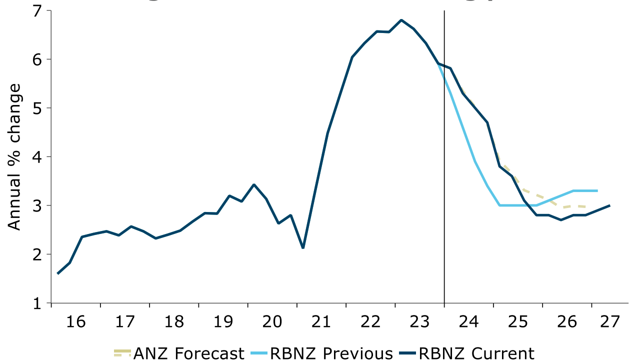
Source: RBNZ, Macrobond, ANZ Research

CPI inflation is a little higher in the near term…



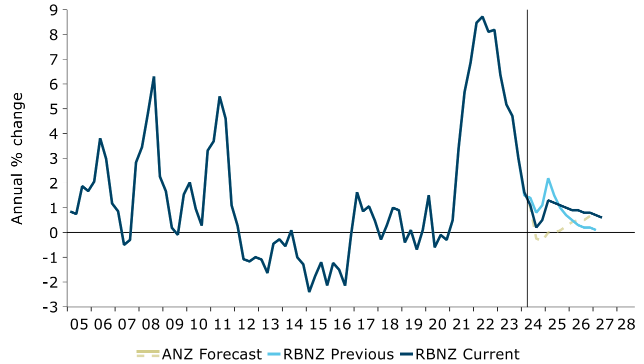
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

…with the higher non-tradables starting point…



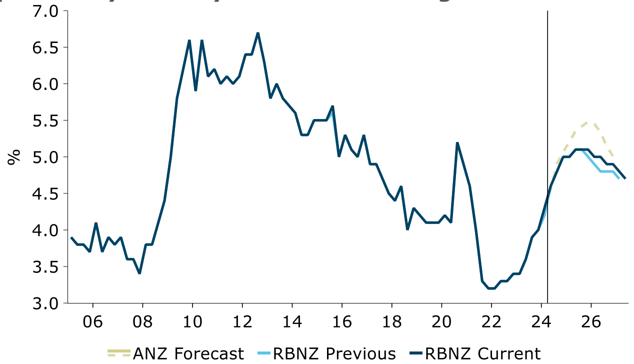
Source: Stats NZ, RBNZ, Macrobond, ANZ Research

…but tradables a little lower in the near term



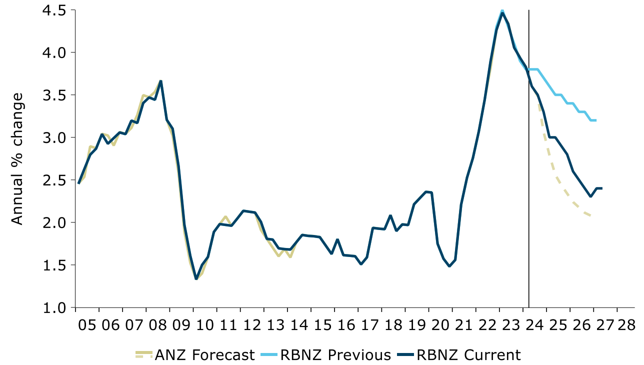
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

The unemployment rate peaks at 5.1%, same as previously but stays there a little longer



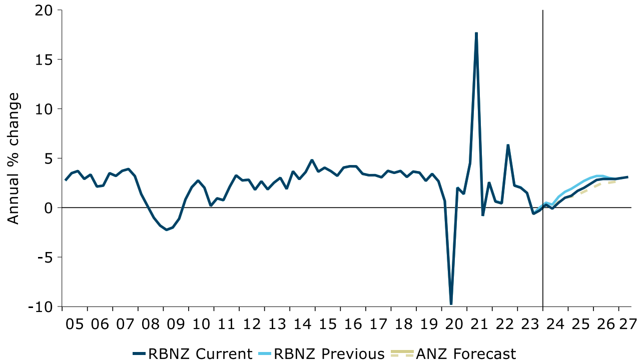
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

LCI wage growth is now looking more consistent with their non-tradables forecast



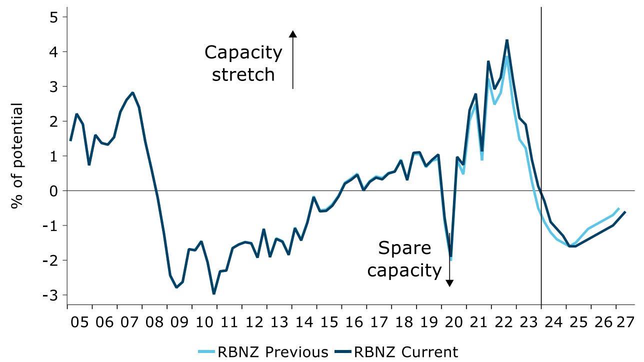
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

GDP forecasts have been revised down a touch…



Source: Stats NZ, Macrobond, ANZ Research

…but a lower potential GDP estimate has more than offset the near-term impact on the output gap



Source: RBNZ, Macrobond, ANZ Research

Contact us

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Sharon Zollner
Chief Economist

Follow Sharon on Twitter
@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, fiscal policy, economic risk assessment and credit developments.

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

Henry Russell
Economist

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

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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