ANZ Research

RBNZ Monetary Policy Statement Review

14 August 2024

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The first cut is the deepest

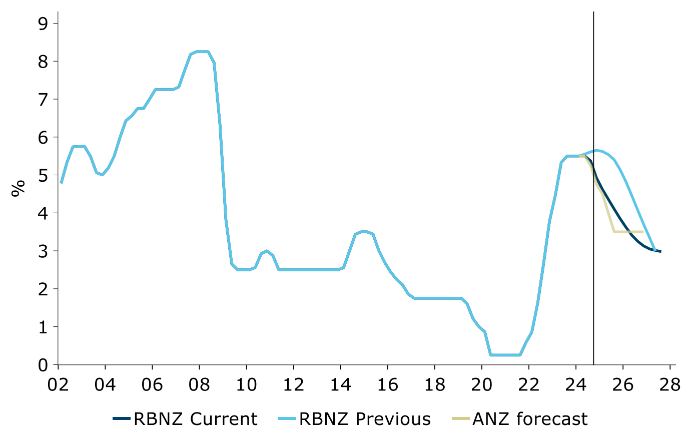
Summary

- The RBNZ cut the Official Cash Rate (OCR) 25bp to 5.25% today in what the Record of Meeting notes was a consensus decision. Its updated forecast OCR track is consistent with 25bp cuts at each of the next three meetings and a slower pace thereafter down to 3.0%.
- There was considerable uncertainty today about how the RBNZ would weigh up high-frequency economic data that rolled over in synchronised fashion in June against the fact that the top-tier data has provided little to justify bringing cuts forward so dramatically from their previous forecast of no cuts until August 2025. We thought the latter would be a meaningful constraint, but the Committee appears to have taken more of a clean-slate approach, based on passing a threshold of confidence in the forward path for inflation. Accordingly, it's a shift to a more forward-looking stance.
- The RBNZ's growth forecasts have been revised down significantly, incorporating negative growth in both Q2 and Q3. CPI inflation is expected to be in the 1-3% band next quarter (we concur), but the near-term outlook is lower due to lower tradable inflation.
- Now the RBNZ has kicked off its loosening cycle, the default decision is a further 25bp cut at each meeting. Our new forecast track accordingly pencils in such a track, to a low of 3.5% as before. In practice, the speed and extent of easing will be highly data dependent.

In brief

Traders and economists were divided about what the RBNZ would (and to some extent, should) do and say today. In the end, the Committee opted to cut the Official Cash Rate (OCR) 25bp to 5.25%. Beyond the OCR decision, the main interest for the market was the forecast OCR track. This was lowered dramatically from the track forecast in the May MPS (figure 1) and now implies cuts at each of the next three meetings, with a slower pace of easing thereafter. The NZD fell in response.

Figure 1. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

Key quotes:

- **OCR decision:** "The Committee reached a consensus to reduce the Official Cash Rate by 25 basis points to 5.25 percent."
- **OCR outlook:** "Members noted that monetary policy will need to remain restrictive for some time to ensure that domestic inflationary pressures continue to dissipate. The pace of further easing will thus be conditional on the Committee's confidence that pricing behaviour is continuing to adapt to a low-inflation environment and that inflation expectations remain anchored around the 2 percent target."
- **Policy transmission:** "The Committee discussed possible reasons for the current economic weakness. Alongside restrictive monetary policy, an earlier or larger impact of tighter fiscal policy could be constraining domestic demand."
- **Labour market:** "The June quarter data suggest that employment growth has slowed, with declines in private sector jobs, hours worked, and wage growth. The impact of government spending restraint and public sector job losses are expected to materialise in further weakening in employment growth over coming quarters."
- **Domestic activity:** "With a broad range of indicators suggesting the economy is contracting faster than anticipated, the downside risks to output and employment that were highlighted in July have become more apparent."
- **Inflation outlook:** "The Committee noted that recent indicators give confidence that inflation will return sustainably to target within a reasonable time frame."
- **Fiscal policy:** "The Committee noted that government expenditure is declining as a share of the economy, with contractionary impacts already felt and expected to continue. However, whether tax cuts will boost consumption is more uncertain."

The RBNZ remains firmly in data-watch mode, as do we. CPI inflation will almost certainly be back in the band in the next print – the RBNZ is picking a very low 2.3% y/y (ANZ 2.6%). They won't have CPI data by the October meeting, but will have two months' worth of Selected Price Indexes. There is still a risk that non-tradable inflation could prove sticky, ultimately slowing the pace of easing.

There's also significant uncertainty about how the economy will respond to lower interest rates. Typically, the OCR is lowered in response to some kind of negative national income and confidence shock, but that's not the case in this deliberate recession. How much activity has been deferred rather than cancelled? Even though it's hard to envisage here and now, given the clear weakness in the economy, there is a risk that activity (and the housing market in particular) could surprise everyone with the speed with which it bounces back. The RBNZ has built in a decline in GDP in both Q2 and Q3, meaning the bar for upside surprises is relatively low.

In the bigger picture, the evolution of a deliberate policy-induced recession and recovery is uncharted territory for all of us, and uncertainty is significant.

RBNZ forecasts in brief

As universally expected, the RBNZ revised down their GDP growth forecasts. They took a bit more signal from the recent soft data than we assumed they would, pencilling in a technical recession over the second half of the year. At the same time, their estimate of the speed limit of the economy (potential output) was revised a touch lower. Together, these changes mean that their output gap forecast (ie how much disinflationary spare capacity there currently is – and will be – in the economy) was meaningfully lowered in the near term, providing the justification for earlier cuts. From the weaker starting point, the RBNZ are expecting relatively sharp recovery over 2025 and 2026 as easier monetary conditions provide support.

The inflation forecasts have been revised lower in the near term, with annual inflation now expected to be in the 1-3% target band in Q3 this year rather than Q4 (this is our forecast also – it's pretty much a done deal). In fact, the RBNZ is now expecting inflation to be quite a lot closer to the target midpoint in Q3, forecasting annual inflation of 2.3%, versus 3.0% in the May MPS. However, the difference comes via the relatively volatile tradables component, with their forecast for non-tradables inflation largely unchanged from May. Labour market forecasts are weaker too, with the unemployment rate expected to peak at 5.4% in early 2025, rising a little more quickly than our own forecast but to a similar peak.

See page 8 for forecast comparisons against the May 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, but the skew around CPI risks is coming through as more balanced.

On the upside, the Committee are weighing up the possibility that potential output slows more than expected, that price-setting behaviour could adjust to lower inflation at a slower pace than expected, and that geopolitical tensions could result in renewed tradables inflation pressures. On the other side, they note downside risks around global growth and China's economy, and also the possibility that wage and price-setting behaviour adjusts more rapidly to low inflation. In other words, there are risks on both sides, and the RBNZ will remain data dependent.

Our take

The RBNZ faced a tricky decision today – turning points are always difficult. But the Committee decided they had sufficient confidence in the inflation outlook to start easing monetary conditions. It's not a riskless decision – there wasn't a riskless option today! But the first cut is the deepest, after all, and if data starts to look a little sprightlier than anticipated, they have potentially boxed themselves in somewhat. In our view, a dovish hold would have provided more optionality, but that's not to say at all that today's decision will ultimately prove to have been a mistake.

Today's decision and forecasts certainly do show that the Committee members are not afraid to change their minds when the facts change. And so, it's going to be all about the data from here. The six weeks before the October Review will reveal how much of the rollover in the June high-frequency data (PMI, PSI, job ads, house sales…) 'sticks'. The market (and the RBNZ's forecasts) are taking a very hefty signal from it, but we have already seen a sharp bounce in the Truckometer and the Barfoot and Thompson auction clearance rate in the last couple of weeks. The data won't necessarily be one-way traffic from here until the end of the year.

Now the RBNZ has started cutting, a 25bp cut at each meeting is the default, so we've pencilled that in as our own forecast for now, down to a low of 3.5% as before. But we do see a real risk that either stickier inflation data or bouncier activity data could cause the RBNZ to slow or stall rate cuts down the track. Of course, on the other side, a negative global shock could see rates fall faster. Forecasting is a highly uncertain business, and the further ahead you're talking, the thicker the fog.

Financial markets

The market got the cut it was hoping for today, necessitating a slight downward adjustment in very short-end rates, with the 1yr swap rate falling around 10bp immediately. But the reaction further out on the curve has been understandably more muted, with the 2yr swap down only 2bp. We think that reflects the idea that having gotten underway early, the RBNZ may not need to cut by as much (or as quickly) as they might have needed to had they waited.

Our new forecast (which is more of a working assumption for now, until we see how the economy responds to the easing cycle now underway) is simply that the RBNZ will likely cut by 25bp at each meeting for the foreseeable future. A track like that would keep short-end rates on a steady downward trajectory from here.

That contrasts with what we have been seeing over the last few months, when short-end rates have been falling in anticipation of today arriving. In the FX space, the Kiwi is lower too, having dropped around 50bp on the announcement. That too reflects the surprise value of today's action, but given that markets have been calling for cuts for some time, they'll likely return to watching the data and global events after today. Indeed, with US CPI due out overnight, local data may fade back into the background for a period.

OCR 5.25% – Monetary restraint tempered as inflation converges on target

OCR reduced by 25 basis points to 5.25%.

New Zealand's annual consumer price inflation is returning to within the Monetary Policy Committee's 1 to 3 percent target band. Surveyed inflation expectations, firms' pricing behaviour, headline inflation, and a variety of core inflation measures are moving consistent with low and stable inflation.

Economic growth remains below trend and inflation is declining across advanced economies. Some central banks have begun reducing policy interest rates. Imported inflation into New Zealand has declined to be more consistent with pre-pandemic levels.

Services inflation remains elevated but is also expected to continue to decline, both at home and abroad, in line with increased spare economic capacity. Consumer price inflation in New Zealand is expected to remain near the target mid-point over the foreseeable future.

The Committee agreed to ease the level of monetary policy restraint by reducing the OCR to 5.25 percent. The pace of further easing will depend on the Committee's confidence that pricing behaviour remain consistent with a low inflation environment, and that inflation expectations are anchored around the 2 percent target.

Summary Record of Meeting – August 2024

The Monetary Policy Committee discussed recent economic and financial developments and their implications for monetary policy in New Zealand.

The Committee noted that the weakening in domestic economic activity observed in the July Monetary Policy Review has become more pronounced and broad-based. Headline inflation has declined, and business inflation expectations have returned to around 2 percent at medium- and longer-term horizons. Committee members agreed that monetary policy restraint can now begin to ease. The pace of loosening will depend on the extent to which price-setting behaviour continues to adapt to lower inflation and inflation expectations remain well anchored to the target mid-point.

Global growth remains below trend across advanced economies. Growth in China has been softer than expected, due to a depressed property market and weak consumer demand. While US growth has been firm, some indicators show emerging weakness. Recent volatility in global asset markets reflects nervousness about US economic prospects, geopolitical risks, and the outlook for international trade policy.

The Committee noted that global inflation has continued to decline but remains elevated in some parts of the services sector in many countries. The Committee noted that some central banks have recently begun cutting policy interest rates, reflecting lower core inflation, weaker activity, and softer labour markets. In this respect, New Zealand's economic activity and near-term inflation indicators now resemble those in countries in which central banks have started cutting policy rates.

While official economic statistics have evolved in line with expectations in the May Monetary Policy Statement, a broad range of high-frequency indicators point to a material weakening in domestic economic activity in recent months. These include various survey measures of business activity, electronic card transactions, vehicle traffic, house sales, filled jobs, and job vacancies. These indicators collectively provide a consistent signal that the economy contracted in recent months. The output gap is now assessed to be more negative than was assumed in the May Monetary Policy Statement, indicating increased spare capacity.

The Committee discussed possible reasons for the current economic weakness. Alongside restrictive monetary policy, an earlier or larger impact of tighter fiscal policy could be constraining domestic demand. Falling net migration may also be playing a role. The Committee noted that measurement challenges, including methodological changes by Statistics New Zealand in the national accounts, are creating additional uncertainty around the composition and likely persistence of this weakness.

The Committee discussed recent developments in the labour market. The June quarter data suggest that employment growth has slowed, with declines in private sector jobs, hours worked, and wage growth. The impact of government spending restraint and public sector job losses are expected to materialise in further weakening in employment growth over coming quarters.

In discussing fiscal policy, the Committee noted that government expenditure is declining as a share of the economy, with contractionary impacts already felt and expected to continue. However, whether tax cuts will boost consumption is more uncertain. While tax cuts could stimulate demand, it is also possible that households might be more cautious about spending in the current economic environment.

The Committee discussed global and domestic financial conditions. Weaker economic data globally have prompted markets to price in lower policy rates for the rest of the year, pushing down sovereign yields in most advanced economies. While domestic financial conditions remain restrictive, they have loosened over recent months. Market expectations for the forward path of the Official Cash Rate (OCR) have contributed to lower wholesale and borrowing rates, along with some depreciation in the nominal exchange rate. The Committee also noted that more households are choosing shorter pricing tenors, meaning that further reductions in mortgage interest rates will flow through to lower household interest costs relatively quickly.

The Committee noted that while credit remains available, demand for credit is weak. This provides a further signal of soft economic activity. High interest rates, sluggish housing market activity and low investment intentions have curbed demand for credit. The agriculture sector has also paid down debt, curbing credit demand.

The Committee considered risks to the financial system. With elevated debt servicing costs and weak economic conditions, some households and businesses are experiencing financial stress. The Committee noted that banks had tightened lending standards in recent years, increased loan loss provisions and were well capitalised, making the financial system more resilient. Non-performing loans have increased from a year ago but remain relatively low by historical standards, and banks are well positioned to support borrowers. In this environment, the Committee agreed that there is no material trade-off between meeting its inflation objectives and maintaining financial system stability.

The Committee discussed inflation developments. Inflation fell considerably in the June quarter, due mostly to lower tradables inflation, while domestic inflation declined in line with expectations. Members were encouraged that surveyed business inflation expectations have returned to around 2 percent at medium- and longer-term horizons. All measures of core inflation have fallen and the components of CPI that are sensitive to monetary policy have declined further. Together with the weaker high-frequency indicators of economic activity, these developments provide the Committee with more confidence that headline inflation is returning to the target band in the September 2024 quarter.

The Committee discussed upside risks to the inflation outlook. The persistence of domestic inflation and the pace at which price-setting behaviour will adjust to a low-inflation environment remain uncertain. Members noted the possibility that firms might adjust prices asymmetrically – changing prices quickly when inflation was high and rising, but more slowly when inflation is falling. The

Committee noted uncertainty around the outlook for potential output, given weak productivity growth. If potential output grows more slowly than currently assumed, there will be less spare capacity and less downward pressure on domestic inflation.

Furthermore, ongoing geopolitical and trade tensions and the global reshoring of manufacturing activities could lead to higher import prices for New Zealand. Members also discussed the significant rise in global shipping costs, caused by ongoing disruptions to Red Sea and Panama Canal freight routes. Given New Zealand's relatively limited trade through these routes, the effect on shipping costs for New Zealand imports are assumed to be more moderate, and feed through to import prices with a lag.

The Committee discussed downside risks to the outlook. Members agreed that a weaker global economy, particularly in China, could dampen demand for New Zealand exports and reduce exporters' earnings. More subdued global demand could also lead to lower import prices.

Members also noted that domestic inflation could fall more quickly than projected if wage- and price-setting behaviour adjusts more rapidly to a low inflation environment. For example, headline inflation will fall sustainably back to the target mid-point more quickly if price and wage setters adjust more to expected future inflation rather than to past inflation.

The Committee discussed the reasons why inflation has been outside of the target range and the expected timeframe for inflation to return to the 2 percent target mid-point. Members noted the lingering effects on inflation from demand effects of monetary and fiscal stimulus, pandemic-related disruptions to supply, increased commodity prices and shipping costs from geopolitical tension, severe weather impacts on local food prices, and low productivity.

Conditional on the information available, the Committee felt that the OCR track in the projection reflected its view on the policy strategy that would best deliver on its remit. The Committee noted that monetary policy settings are consistent with annual headline CPI inflation remaining within the target band near the 2 percent mid-point over the forecast horizon.

The Committee observed that the balance of risks has progressively shifted since the May Monetary Policy Statement. With a broad range of indicators suggesting the economy is contracting faster than anticipated, the downside risks to output and employment that were highlighted in July have become more apparent. Members were also concerned about avoiding unnecessary near-term instability in output and employment given the evolution of recent indicators.

In discussing the appropriate stance of monetary policy, the Committee noted that recent indicators give confidence that inflation will return sustainably to target within a reasonable time frame. With headline CPI inflation expected to return to the target band in the September quarter and growing excess capacity expected to support a continued decline in domestic inflation, the Committee agreed there was scope to temper the extent of monetary policy restraint.

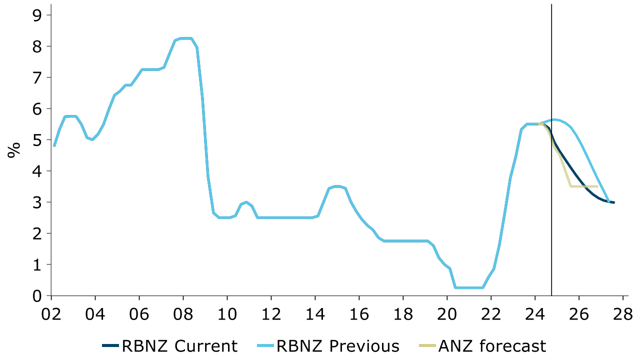
However, members noted that monetary policy will need to remain restrictive for some time to ensure that domestic inflationary pressures continue to dissipate. The pace of further easing will thus be conditional on the Committee's confidence that pricing behaviour is continuing to adapt to a low-inflation environment and that inflation expectations remain anchored around the 2 percent target. On Wednesday August 14, the Committee reached a consensus to reduce the Official Cash Rate by 25 basis points to 5.25 percent.

Attendees

MPC members: Adrian Orr (Chair), Bob Buckle, Carl Hansen, Christian Hawkesby, Karen Silk, Paul Conway, Prasanna Gai
Treasury Observer: Dominick Stephens
MPC Secretary: Calista Cheung

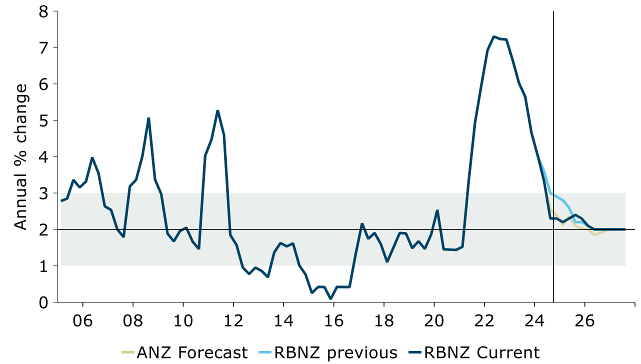
Key forecasts: Activity downgraded a lot, inflation downgraded a touch

The RBNZ has lowered their OCR track significantly



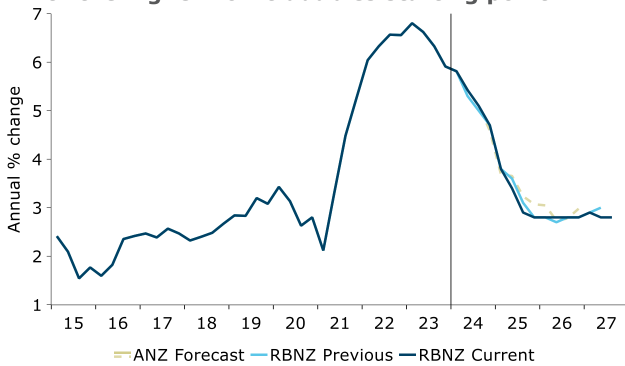
Source: RBNZ, Macrobond, ANZ Research

CPI inflation is a little lower in the near term…



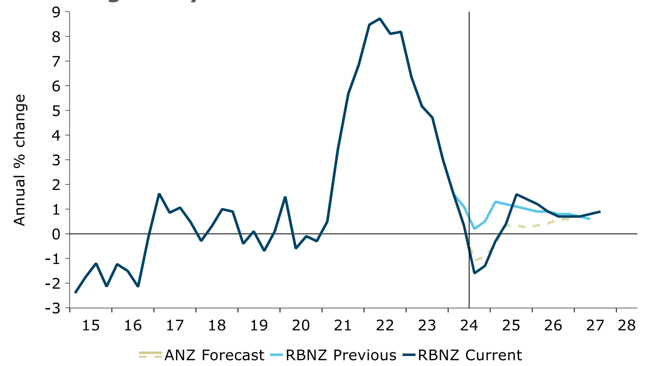
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

…with the higher non-tradables starting point…



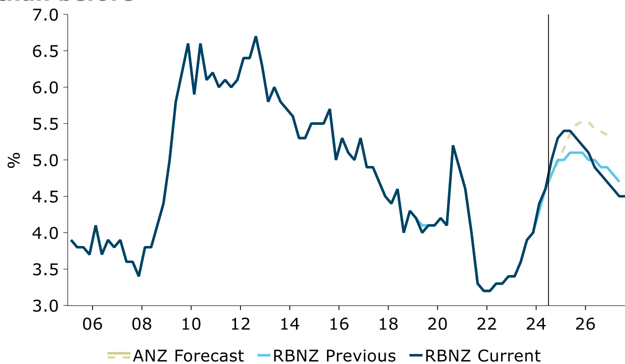
Source: Stats NZ, RBNZ, Macrobond, ANZ Research

…outweighed by much lower tradables near term



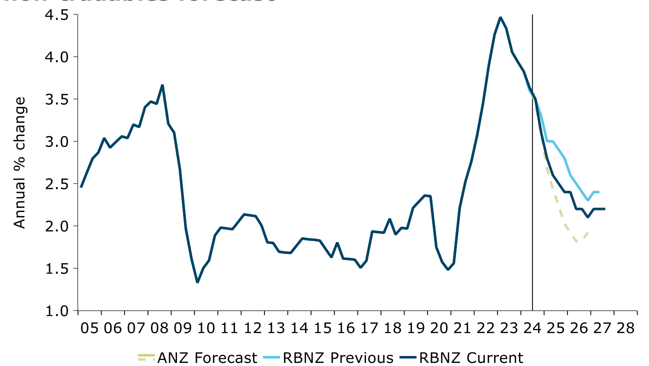
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

The unemployment rate peaks at 5.4%, a little higher than before



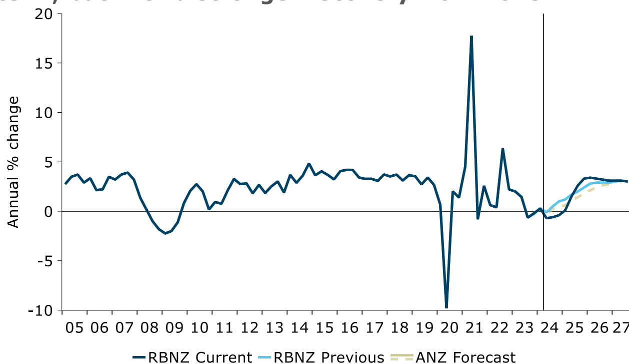
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

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



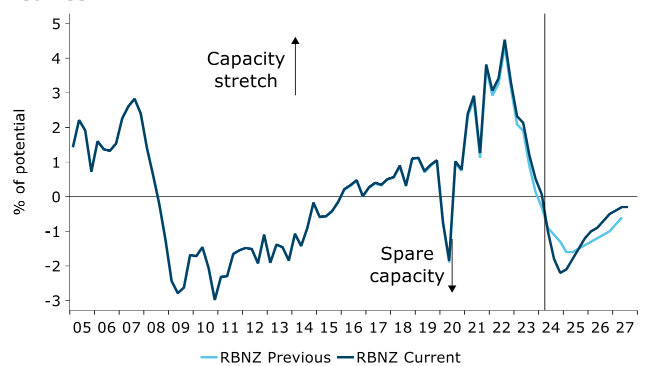
Source: RBNZ, Stats NZ, Macrobond, ANZ Research

GDP forecasts have been revised down in the near term, but with a stronger recovery from 2025…



Source: Stats NZ, Macrobond, ANZ Research

…which is reflected in a weaker output gap in the near term



Source: RBNZ, Macrobond, ANZ Research

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