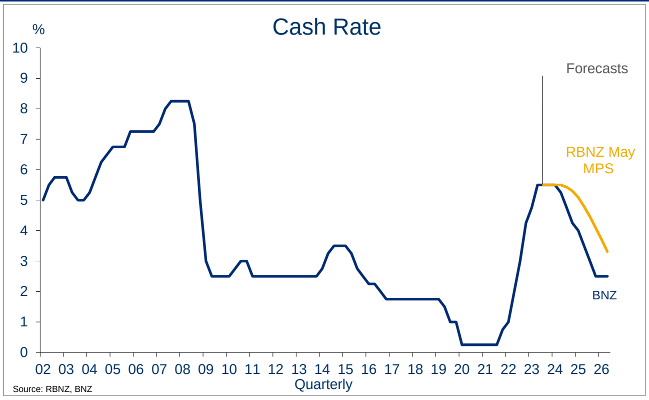
8 August 2023

RBNZ August Monetary Policy Preview

- **RBNZ to maintain 5.5% cash rate**
- **Interest rate track very close to May print**
- **Labour market softening more than expected**
- **Inflation not quite so**
- **Two-sided risks to future outcomes warrant caution**

We believe the Reserve Bank of New Zealand will publish an interest rate track that is almost identical to that which it produced in its May Monetary Policy Statement. This means the cash rate is unchanged when the RBNZ releases its August 16 update and that it is forecast to stay that way until late in 2024.

No need to change

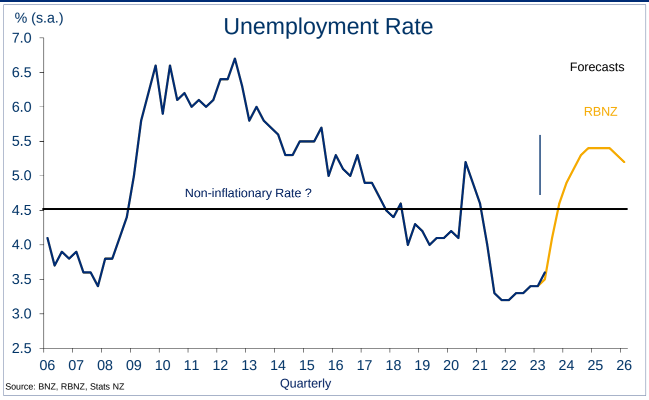


If there is any deviation from that track it will send a strong message to markets that its view is changing. We would argue that the risks to the Bank's previous track are expanding on both sides of the central view but that, on balance, things are turning out very much as the Bank has expected.

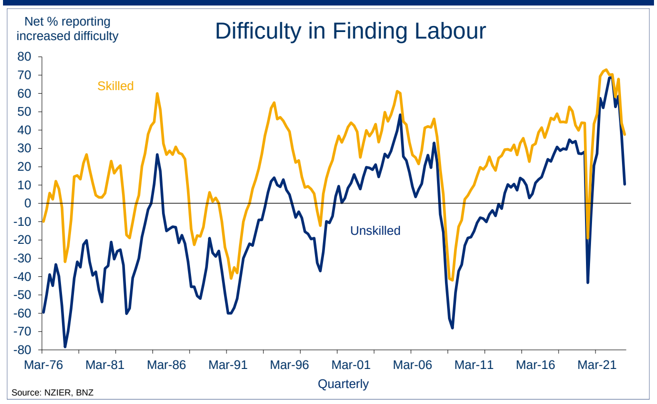
To start with, the labour market is proving to be very well behaved in making its way towards Maximum Sustainable Employment (MSE). The June quarter unemployment rate of 3.6% was 0.1% higher than the RBNZ had anticipated. Even more importantly, the annual increase in the Labour Cost Index was 4.2% compared to a 4.3% pick.

The underutilisation rate, which goes into the Bank's MSE calculations jumped from 9.1% to 9.8% and survey measures of difficulty in finding labour, and the constraints that difficulty imposes, have all turned favourably in the direction desired. Labour turnover is also falling markedly and we are just beginning to get media reports of layoffs, something not seen for some time.

Labour market behaving



Labour shortages ease

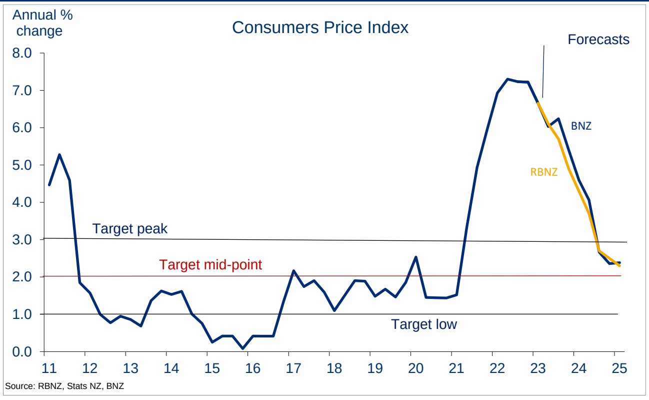


Some will point to the greater-than-anticipated spike in employment (1.0% for the June Quarter compared to a 0.6% expectation) but this reflects more the immigration-led surge in supply than any increase in the demand for labour. Indeed, employment intentions continue to trend lower.

One could argue the lower than anticipated Q2 CPI (6.0% annual versus a 6.1% RBNZ pick) adds further weight to the RBNZ's "success story" but we are loathe to draw this conclusion as non-tradables inflation remained stubbornly high. Moreover, we believe the RBNZ will need to raise its short term inflation forecasts and, conceivably, by a significant margin. Currently, we are forecasting a 2.4% increase in the September quarter CPI compared to an RBNZ May estimate of 1.8%. A decent chunk of the deviation can be attributed to the recent surge in petrol prices over and above that caused by the removal of government fuel subsidies. The RBNZ would be fully justified in looking through this. In contrast, the remaining differential, largely driven by persistent non-tradables inflation, will provide some cause for concern.

Our view is that the expected near-term deviation will be relatively short lived but was this to feed through into heightened inflation expectations the RBNZ would certainly become increasingly uncomfortable. For now, we think that the Bank will have to acknowledge this concern but report that its medium-term view that annual CPI inflation is back within the target band by mid-2024 still holds.

A fleeting concern?



There are, of course, other factors at play which should avert any knee jerk reaction to these rising CPI pressures. Of key importance in this regard is the fact that the economic outlook continues to deteriorate. While Q2 and Q3 GDP may be very modestly positive we think Q4, 2023 and Q1, 2024 will print negative.

There are a number of factors that will drive this:

- Slowing global growth
- Slower migration growth
- Slower tourism growth, as the impact of the FIFA World Cup abates
- The lagged impact of past rate increases fully hitting home
- Investment slow to recover from General Election uncertainty
- The impact of the cut in the dairy payout filtering through the economy
- A deteriorating terms of trade weighing on activity

With all this going on, now would seem a completely inappropriate time to contemplate tightening. Sure, slower growth in and of itself does not guarantee lower inflation but if it is accompanied by rising unemployment there is a good chance that it does.

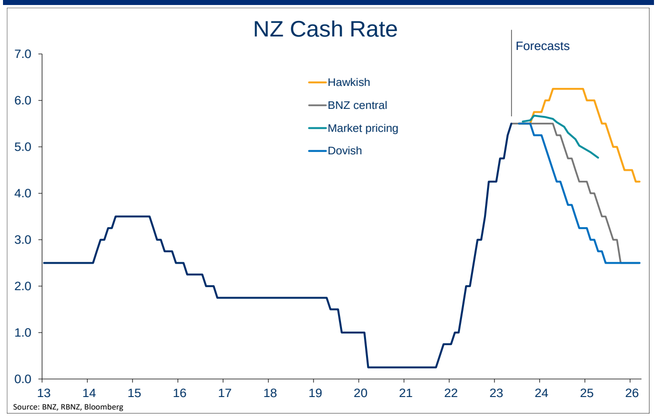
As if all this was not enough, note that bank lending rates have been creeping higher meaning that effective monetary conditions have tightened a tad even without the RBNZ doing anything.

It is also important to note that the RBNZ has intimated there is now a high hurdle for it to raise rates again. One can't help but think that the final 25 basis points, delivered in May, was a decision to set monetary conditions slightly tighter than was considered necessary rather than the alternative no-change decision which risked conditions being slightly too lose. On this basis, it seems there is now a relatively high hurdle for the Bank to move again, a hurdle that won't have been met by recent developments. Could the RBNZ hike interest rates again? Absolutely. If, post-election, wage growth remains strong, non-tradables inflation proves sticky, inflation expectations are elevated and the incoming government delivers a major fiscal stimulus then the RBNZ could well swing back into action. For the Bank to recommence the tightening cycle it would have to be pretty sure inflation was a problem. This being so, we stress that if the Bank makes the decision to hike it won't be to hike once. If the RBNZ pulls the trigger then expect a minimum of two hikes and quite possibly more. Our hawkish alternative scenario for the Bank is thus 25 point hikes in November, February and April.

But the risk profile is not one sided. Just as plausible is a New Zealand economy that goes more deeply into recession than we anticipate as lagged interest rate impacts coincide with a US recession, a further slowing in the Chinese economy, weak commodity prices and an El Nino induced drought. Under this scenario an easing in monetary conditions will come a lot earlier than currently expected.

The Reserve Bank will be very aware of these two-sided risks. One could argue that, at the moment, the risk profile is very marginally tilted to the hawkish side but certainly not so much that the RBNZ would act on it.

Nothing is given



It is this balance of risk that has us believing the RBNZ will print the same interest rate track. The market will look for any deviation, however small, from the May statement as a sign as to which way the RBNZ is leaning. Given the way markets work, any shift risks a sharp market response. The RBNZ will need to be very mindful of this when producing its track lest it generate an overly zealous market response contrary to its intent.

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