22 May 2024

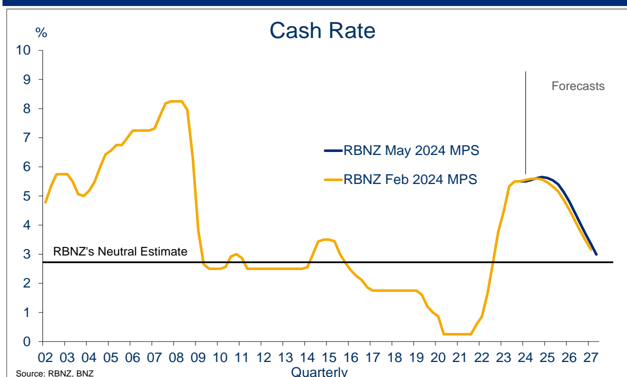
RBNZ Hawkish

- **Cash rate kept at 5.5%**
- **Further rate hike threatened**
- **As near term inflation surprises and potential growth lowered**
- **This despite acknowledgement of faltering economy**
- **We push back first cut to February 2025**

The Reserve Bank of New Zealand has today delivered a clear warning it is still thinking about raising rates. We don't think this will happen, but a shot has been clearly fired across the bow.

The RBNZ left the cash rate at 5.5% at today's Monetary Policy Statement but, contrary to popular opinion, raised its modelled cash rate track. And, in the summary record of meeting, the tone was unequivocally hawkish. Indeed, it was noted that the Monetary Policy Committee contemplated raising rates at this meeting. To cap things off, the rate track has a peak of 5.65% implying there is a greater than even chance of a rate hike.

A higher track

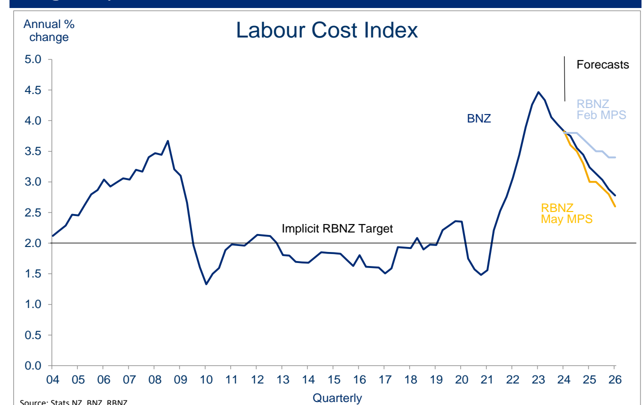


We have been noting that there is a very real chance the RBNZ would need to lower its GDP growth assumptions and, in so doing, create a larger output gap leading to a softening inflation outlook. It did lower growth but changes in its supply side and productivity assumptions resulted in the previously forecast negative output gap shrinking.

This is important because the chance that growth will now surprise to the downside is sharply reduced.

We had also thought the Bank would raise its unemployment forecasts. It has not. We think there remains a big risk that it is surprised to the upside on this front. However, the main reason a higher unemployment rate feeds into lower inflation is via wages. So, it is notable the Bank has significantly lowered its Labour Cost Index inflation projections to be consistent with the 5.5% unemployment peak that we are forecasting. This being so, any upside surprise in unemployment may not necessarily change the RBNZ's inflation and interest rate view.

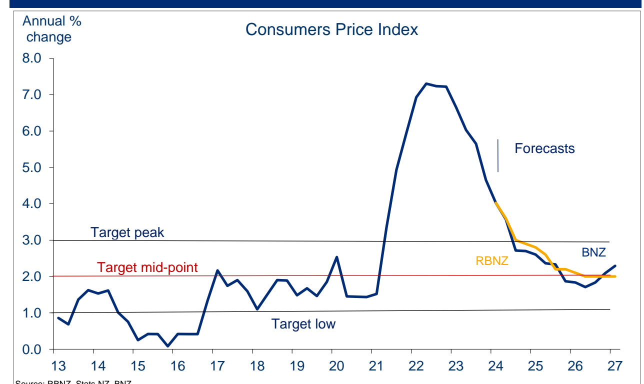
Wage expectations slashed



We should say that we find it hard to believe the Bank's significant change in wage expectations doesn't seem to water down its medium-term inflation views in any meaningful way.

With the impact of a weaker economy ruled out as a reason to present a more relaxed stance on medium term inflation, this left the door open to the Bank concentrating on the near-term surprise to inflation. We had been warning that near term inflation would be higher than the Bank had anticipated and we had produced near-term inflation forecasts higher than it had published. Now, however, the RBNZ's forecasts are even higher than our own.

A short term inflation focus



Of great importance is the fact that the Bank no longer believes annual inflation will fall to well within its target zone in the September quarter of this year. It has revised annual CPI inflation for Q3 to 3.0% from 2.6%. It only sneaks within the target range, 2.9%, in Q4 2024.

Our view that the RBNZ would lower the cash rate at its November meeting was predicated on annual inflation being within the band. If the Bank's forecasts prove accurate then this would mean the first opportunity for a cut would be February 2025.

Another key piece of information the Bank needs before settling on its likely course of action is the detail of the Budget due for release May 30. We were somewhat bemused by the Bank's approach to fiscal policy. In short:

- Because the Bank has lowered its potential GDP forecast, the government expenditure track already provided in the Half Year Economic Update has become more stimulatory than previously anticipated.
- It notes any stimulus from tax cuts included in the Budget could well be offset by declines in government spending but that timing differences in the impacts pose "an upside risk" to the forecast of aggregate demand.

In other words, the Bank has already decided the fiscal position is likely to be more inflationary than previously anticipated. This provides the very real risk that it proves to be even more so come Budget day.

At the time of the February MPS, the Reserve Bank implied the first rate cut would occur in the second quarter of 2025. Now the implication is that we will be waiting until late 2025 for this to occur.

We continue to believe the Bank will be able to lower rates sooner than it currently projects. We will be looking to produce a weaker set of economic forecasts than we currently have considering what the RBNZ looks set to do with its cash rate. This should help lower medium term inflationary pressure further. Nonetheless, given what the Bank has said today, we feel the need to move our forecast first rate cut back to February 2025. This is not to rule out November but were we to keep with a November forecast this would imply an equal chance of an August and February move at a time when August is looking very unlikely.

Note that our forecast profile for further rate cuts remains the same we have simply shifted the starting point.

As for the prospect of another hike, we think this unlikely. That said, it is not at all clear what the Bank thinks. In its post-match press conference, we were told that the Bank's published rate track was the base case, implying a 60% chance of a rate hike. We were also informed that "raising rates was a real consideration". But to confuse matters it was suggested that we should be sceptical that the track implied a rate hike.

On the basis that we don't think there is any justification for higher rates we will stick with our no-hike assumption even though we can't quite make out what the Bank's view is.

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Full text from Monetary Policy Statement

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

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