Research
Economy Watch

14 August 2024

RBNZ declares victory against inflation

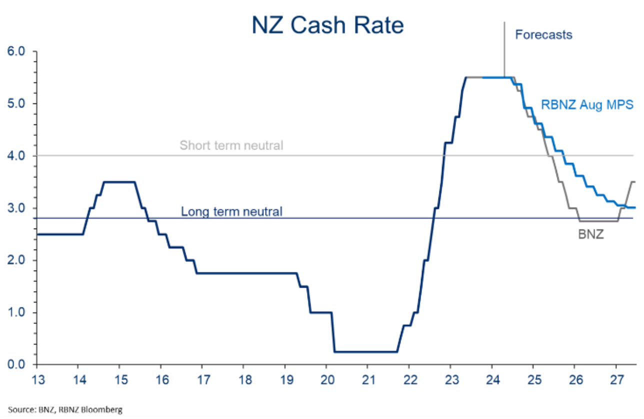
- **Cash rate cut 25 basis points to 5.25%**
- **Three more cuts pencilled in over the following three meetings**
- **Wider expected output gap the key driver**
- **No change to our interest rate forecasts**
- **We expect further cuts in October and November**

After 15 long months of extremely tight monetary policy, the RBNZ has given the green light to progressively lower interest rates. Not only did it cut the cash rate 25 basis points to 5.25% today but it also published a rate track which implies a further three 25 point cuts by February next year on its way to an eventual low of 3.0%.

This will be welcome news to businesses and the household sector but it should not be forgotten that the lags between rate moves and economic impact can be long and monetary conditions remain restrictive.

There was nothing in today's Monetary Policy Statement to change our view of the world. We have more cuts than the RBNZ next year but that's a long way away and we wouldn't make much of the apparent difference in view. More importantly we have the cash rate troughing at 2.75% which is not dissimilar to the RBNZ's proposition.

Interest rate normalisation begins

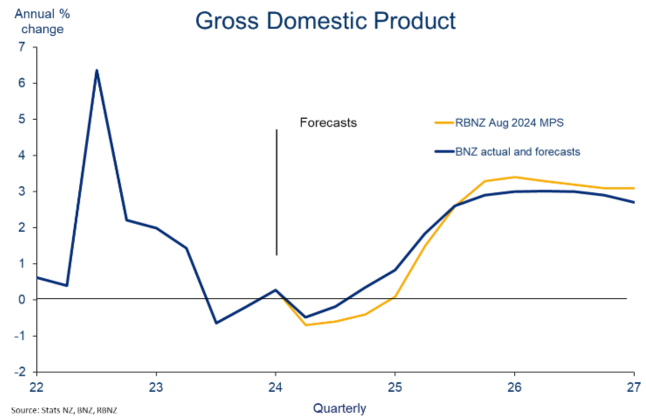


There appear to be mixed interpretations of the RBNZ's decision from market players. Some see the statement as still being hawkish because the RBNZ is not suggesting rate cuts as aggressive as was priced into the market immediately before the announcement. Others think the RBNZ will soon be forced into moving in 50 point licks.

Looking forward, we stick with our view that the RBNZ will lower rates a further 25 basis points at its October Monetary Policy Review. Barring some disastrous partials, or a global shock, a 50 point cut would seem unlikely.

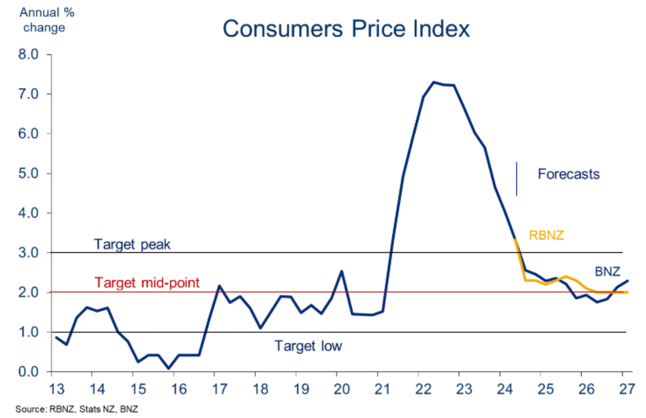
Bear in mind the Reserve Bank has significantly lowered its growth and inflation forecasts since its May MPS. It now sees June quarter GDP at -0.5% and September quarter at -0.2%. This cumulative 0.7% decline compares with a previously expected increase in activity of 0.4% over the period. It would require some very weak data to have the RBNZ lower this expectation much more in the near term.

RBNZ forecasting weak growth



Similarly the RBNZ is now forecasting annual CPI inflation to slump to 2.3% in the third quarter of this year. This is well down on the 3.0% previously forecast and is even 0.3% below our own forecast. Partial indicators released tomorrow morning will shed some light on the likelihood of the RBNZ's forecast coming true.

Inflation tamed



We are not saying a 50 point cut is impossible at some stage in this easing cycle but we are saying it is unlikely any time soon. Moreover, the RBNZ has now moved its rate track significantly, based on sufficiently weak inflation and growth expectations. If these assumptions are not met there is also the risk of a pause along the way.

There will be those who criticise the Bank for cutting so soon after a May MPS which introduced a tightening bias. We do not think this criticism is warranted. If the data moves against your expectations, then you move your stance. This is what the Bank has done. However, back in May we questioned the decision to adopt that tightening bias and we think that in hindsight folk will come to accept that May was a mistake, not today's decision.

In short, the reason the Bank has done what it has is that its "forecast output gap is now assessed to be more negative than was assumed in the May Monetary Policy Statement". This was based on a "broad range of high-frequency indicators pointing to a material weakening in domestic economic activity in recent months". We couldn't agree more with this assessment.

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Full text from today's Monetary Policy Statement:

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

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