Research
Economy Watch

bnz MARKETS

1 October 2024

RBNZ to accelerate rate cuts

- **QSBO just awful**
- **CPI headed sub 2.0%**
- **Soft labour market to subdue non-tradables**
- **Rate settings need to move quickly towards neutral**
- **50 basis point cut at October meeting warranted**

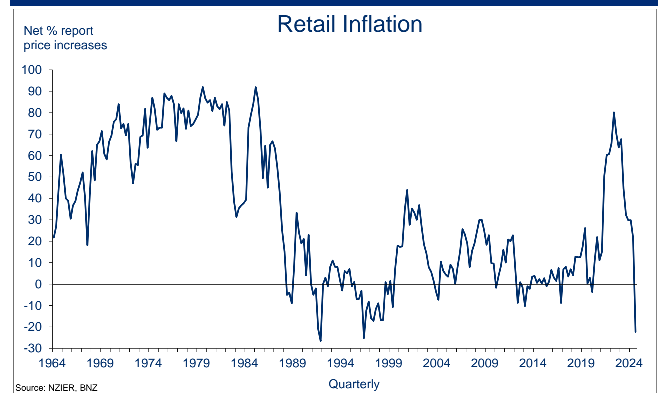
We have been increasingly pointing to the fact that October's Monetary Policy Review could be a line ball call between a 50 basis point cut and a 25. Not cutting at all has never entered our minds. And a line ball call it is. We'd hoped that the ANZ Business Opinion Survey and today's QSBO would deliver the same message, and in so doing settle the argument. But they haven't, with the ANZ survey delivering a hawkish message and the QSBO a starkly dovish tilt.

So, what the RBNZ decides to do next week may come down to the weight it puts on the starting point as opposed to what some of the leading indicators say about where we might be in twelve months' time. With this in mind, note that the ANZ survey questions businesses about where they see things one year hence while the QSBO asks about the next three months. Therefore, it should be of no surprise that the shorter term view is far more miserable as very few businesses will be expecting a sudden lurch to the positive.

In our opinion, we think the disinflationary information that we have received will dominate and that this will, ultimately, encourage the RBNZ to accelerate the easing process. In line with this, we think the Bank places more weight on the NZIER survey than the ANZ one, as evidenced by the number of indicators that it used when analysing maximum sustainable employment.

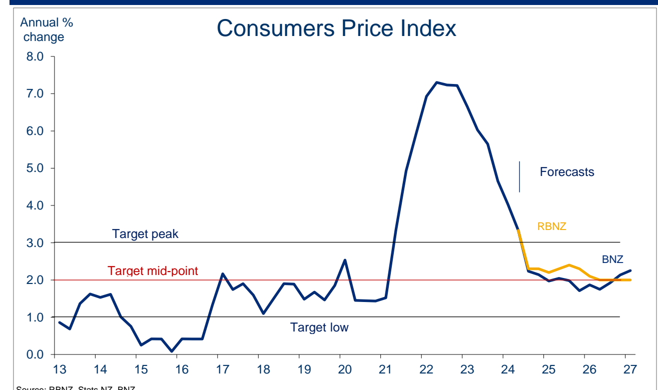
The containment of inflation is the Reserve Bank's goal. And the vast majority of the data now say that this objective has been achieved. Moreover, there is a growing body of evidence that says annual inflation could soon fall below the 2.0% mid point of the Reserve Bank's target band. Indeed, we are forecasting it to be 2.0% by March 2025 falling to 1.7% by December 2025. And the balance of risk is increasingly to the downside especially when you look at the fact a net 22% of merchants reported that they had lowered selling prices in the September quarter. Only twice in the history of this series, dating back to the 1960s, have weaker results been posted.

Deflation!



Our inflation forecasts are already lower than the Reserve Bank's. In part the difference will be due to recent declines in petrol prices which will not have been incorporated into the Bank's published forecasts. In one sense the RBNZ should look through petrol price movements but to the extent that headline inflation falls faster than expected it should drive inflation expectations lower. A big plus in the eyes of the Bank.

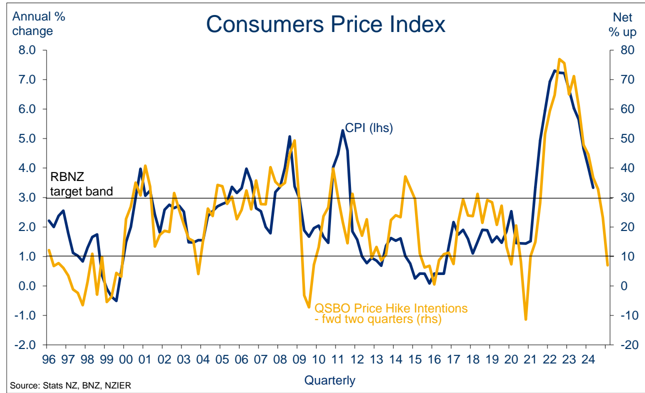
CPI inflation on target



But the downside possibilities don't finish here. The NZD TWI is currently 71.9 compared with an RBNZ estimate of 69.5. This is potentially enough to drop a further 0.3% off the Bank's annual inflation projections, all other things being equal. Of course, all other things are not equal and one has to take into account improved commodity prices (especially dairy) and a stronger China outlook but we still think the pressure on future inflation is down.

Perhaps, more importantly, the QSBO shows us that pricing intentions have plummeted. A mere net 7% of respondents now intend to raise selling prices. Excluding the COVID lockdowns this is the lowest reading since September 2015, a time when the fear of deflation was at its peak. And we think a reading of this magnitude is consistent with annual CPI inflation falling to sub 1.0%.

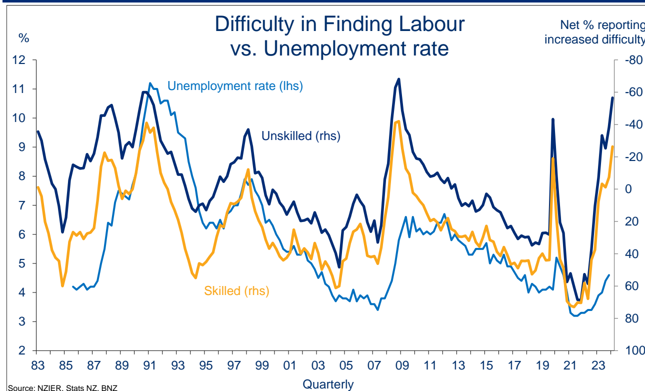
Pricing intentions plummet



One of the RBNZ's bugbears is that non-tradables inflation remains too high. Wage costs are a significant driver of non-tradables inflation and today's QSBO shows that the conditions are ripe for wage inflation to abate rapidly. Falling service sector pricing intentions also support lower non-tradables inflation.

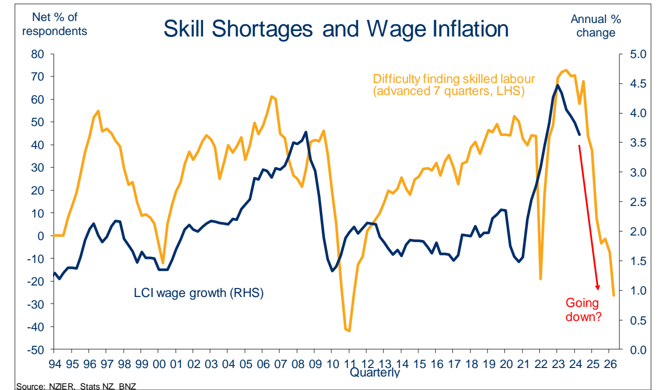
There was a significant increase in the ease with which businesses are finding labour. A net 26% said skilled labour was easier to come by. A net 57% said its easier to find unskilled labour. This degree of ease was last reported during the GFC when the unemployment rate was heading to 6.4%. Not only does this put downward pressure on wage growth but it supports our view that the unemployment rate will head higher than the RBNZ has forecast.

Labour shortages disappearing



Adding support to these views is the fact that just 5% of businesses report labour as their major factor constraint. This indicator is closely watched by the RBNZ and provides a very good indicator of wage inflation pressures.

Wage pressures dissipating



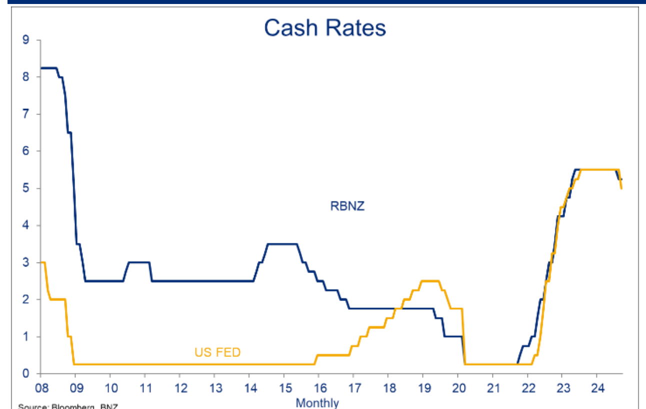
Incidentally, recent SEEK wage data also confirms a moderation in wage growth. In the third quarter 2024 wages were 3.7% up on year earlier levels. This compares with 4.4% a quarter earlier and a peak of 5.1% back in Q4 2023. The quarterly increase of just 0.7% implies greater softening in the annual reading to come.

Growth indicators in the QSBO provided further evidence that the economy will recover in the manner we have been projecting but it will be a while before the extent of that growth absorbs the space capacity developing in the labour market, closes the current output gap and, in turn generates inflationary pressure. In short, the RBNZ is now in a position where it desperately needs to encourage growth if it is to prevent inflation falling too far.

Notably, a net 84.5% of service sector respondents (the only ones asked this question) report that they believe interest rates will fall so even the modest growth expectation is dependent on this. What they don't say is how much they expect rates to fall.

Some folk would say the recent decision by the Federal Reserve to cut its funds rate by 50 basis points is a game changer for New Zealand. We are not in this camp. Firstly, the RBNZ does not always follow the Fed and, secondly, as the RBNZ has already cut once a further 25 would match the Fed's move. Nonetheless, the general push for lower interest rates globally will have a bearing on the Reserve Bank's stance.

Fed helps, a little



While we are now touting a 50 point move we accept that this is a bold call and that a conservative central bank could easily balk at an acceleration. If the Committee so wanted it could point to:

- the strength in the ANZ survey;
- the fact that Q2 GDP surprised to the upside with activity levels now 0.2% higher than anticipated and private consumption 1.3% above expectations;
- ongoing elevation in non-tradables inflation;
- an increase in confidence in the housing market;
- concern that an acceleration might be criticised by some as another RBNZ change in view;
- concern that current market pricing for future rate cuts is overdone.

Market pricing could yet play a part in the Reserve Bank's decision. Currently 40 basis points of cuts is priced for October. A clear repricing towards 25 or 50 could have a big influence on the outcome.

We have long argued the Reserve Bank has been slow to cut rates in the face of an imploding economy, weakening labour market and a return of inflation to target. Also, the cash rate is clearly above neutral at a time when the evidence that it does not need to be is extensive. On this basis we think the Reserve Bank should take the opportunity to return the cash rate to near neutral as soon as is practical.

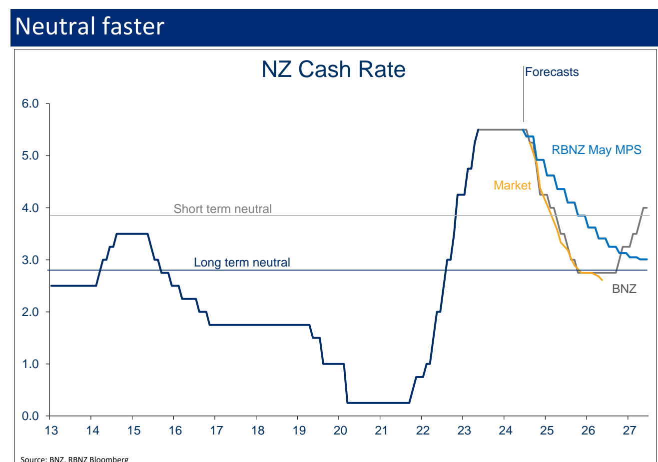
It's difficult to know exactly where near-term neutral is but given recent RBNZ calculations, and those of our own, it would seem that a move towards 4.0% (or below) is warranted. On this basis, we believe that if the October 16 CPI report confirms inflation is under control (as we expect) then a further 50 point cut would make sense in November.

The cash rate would then go into the long break between November and February still tighter than neutral at 4.25%. The break would then give the RBNZ time to comprehensively reassess the situation. Given the extent of the cuts that would have been delivered at the tail end of 2024, and the lags between rate changes and an economic response, it would probably then be apt for the RBNZ to moderate the pace of its rate reduction back to 25 points a meeting.

We still think the cash rate will trough at 2.75%. It will just get there a little earlier than previously anticipated.

If instead the RBNZ takes the conservative option and cuts 25 basis points next week, and we repeat that we do not rule this out, we would most likely still forecast a 50 point move for November with a chance of a further 50 in February 2025. So, the main message here is that we anticipate the cash rate to be at least 125 basis points lower than where it is now by the end of April next year i.e 4.0% or lower. Given this, although we are taking a seemingly bold approach to our expectations for rates, we note that we remain less aggressive than the market, which seems set on pricing in a 3.5% cash rate by April.

Neutral faster



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