Research

Economy Watch

16 August 2023

RBNZ Stands Pat

- **Cash rate left at 5.5%**
- **Rate track nudged higher**
- **But Orr says nothing in it**
- **Bank says neutral rate has lifted to 2.25%**
- **Nothing to change our view of the world**

In our view the wheels are starting to well and truly fall off the New Zealand economy. In today's August Monetary Policy Statement the Reserve Bank recognises this in assuming the economy goes back into recession in the second half of this year. In our opinion, the risk is that the downturn turns out to be more aggressive than any of us have anticipated. Recent data are certainly suggestive of this. The BNZ-Business New Zealand PMI and PSI have both turned nastily negative, dairy commodity prices are slumping knocking the stuffing out of rural sector earnings that were already under pressure, spending on discretionary items is falling, surging petrol prices and rising interest rates are squeezing the household sector, and the recent boom in immigration and tourism looks set to slow. What chance is there against this backdrop that the Reserve Bank would raise its cash rate any time soon? Very little is what we would contend.

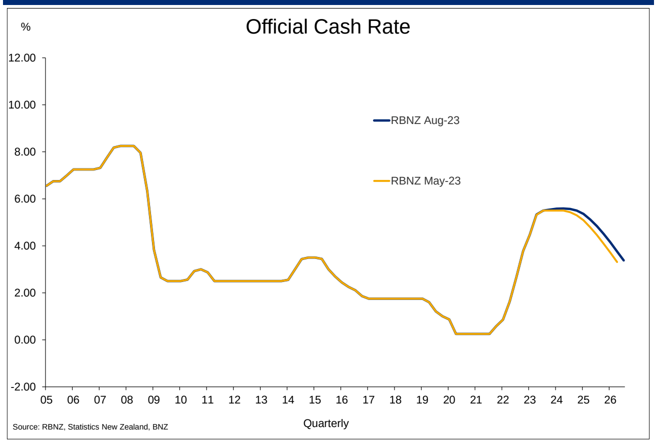
Yet, even in this environment, inflation refuses to die. In fact, inflation has recently accelerated thanks to local body rates, an excise tax hike, insurance costs and rapidly rising petrol prices. Some of these factors can be looked through but others cannot. And, more importantly, there is always the very real chance heightened headline readings feed into raised inflation expectations which, in turn, help keep inflation elevated for longer. This process is exacerbated by the apparent increase in indexation that appears to be occurring across the economy.

The Reserve Bank will be wary of this and, as such, has given no indication that weakening growth will yet have it contemplating rate cuts any time soon.

As it turns out, the RBNZ actually tweaked its rate track modestly higher with the model-projected cash rate now peaking at 5.59% in June 2024, 9 basis points above what it published in the May Monetary Policy Statement.

This could be interpreted as an indication from the RBNZ that it thinks there is a greater chance of a hike in the next twelve months than a cut. So, mildly hawkish at the margin but certainly nothing that says a further rate hike is likely.

RBNZ slightly more hawkish?



Possibly cognisant of the persistence of inflationary pressure, the Bank also lifted its longer dated track such that the projected cash rate at the end of December 2025 is now 4.5%, up from 4.1% previously.

It would, however, be remiss to think the majority of the interest rate adjustment was due to a central bank that had become more nervous about the outlook. To start with Governor Orr, in his press conference, noted that the rate track is model-driven and that there was no signal in the published shift.

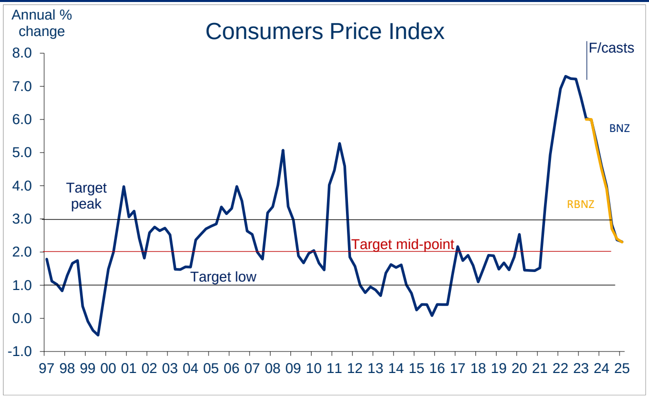
Also, a likely contributing factor to the adjustment is the fact that the Bank has shifted its estimated neutral rate to 2.25% from 2.00%. All other things being equal, this means the cash rate needs to be 25 basis points higher to create the same degree of tightening as previously estimated.

Perceptions of neutrality nearly always cycle with a lag to actual rates. On this basis we think the Bank will progressively raise its estimates. Our gut feel is that these revisions will continue well into the 3s before all is said and done. This is one of the many reasons why we do not believe interest rates will trough anywhere near as low as they did in the last cycle and why we are strongly of the view that, on average, the cash rate will be significantly higher over the next ten years than it was over the last ten.

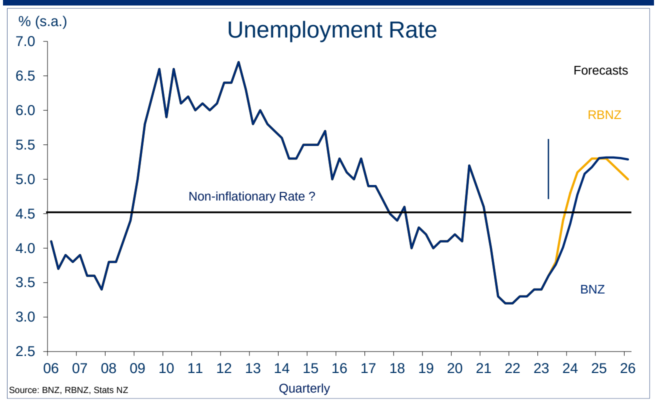
This is not to say the cash rate can't fall to sub 3.0% at the bottom of the upcoming rate cycle. After all, rates typically trough below neutral in order to stimulate economies in the same way as they peak above neutral to slow the economy down. Whatever your estimate of neutrality, we think you can safely conclude interest rates are well and truly contractionary at the moment.

For now, we see no reason to change our forecast interest rate track. Our estimates of inflation and the labour market are very similar to the Reserve Bank's so there is little fundamental reason why our rate track should differ markedly from the RBNZ's track or from our pre-MPS view.

RBNZ CPI track matches our own

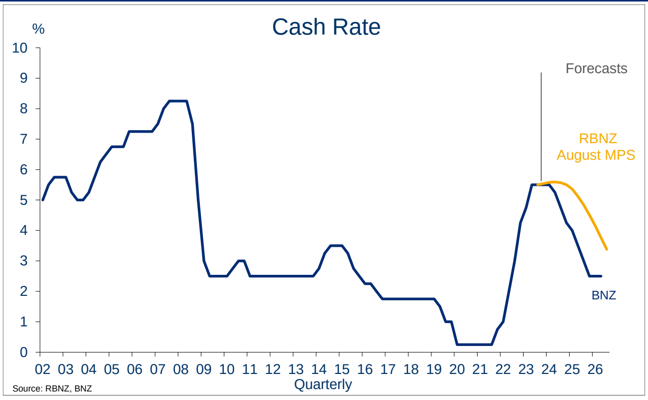


Labour market views similar too



Despite the similarities in our forecasts, we reiterate that there is a very real risk the economy weakens more than expected resulting in an earlier easing by the Bank than it currently believes. Nonetheless, we do accept that the risk of inflation becoming more persistent is rising despite the weakness in the economy. Accordingly, we equally acknowledge that there is a chance rates stay higher for longer than we are projecting and that the trough in our rate track is modestly too low.

Downside risk dominates



Financial markets appear to have read today's statement as mildly hawkish with a tickle higher in swaps yields and a 20 point lift in the NZD. This seems logical enough though we still don't think the market will get the 25 basis point rate increase that is now roughly 55% priced by February of next year.

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Full text from Monetary Policy Statement

The Monetary Policy Committee today agreed to maintain the Official Cash Rate (OCR) at 5.5%.

The current level of interest rates is constraining spending and hence inflation pressure, as anticipated and required. The Committee agreed that the OCR needs to stay at restrictive levels for the foreseeable future to ensure annual consumer price inflation returns to the 1 to 3% target range, while supporting maximum sustainable employment.

The New Zealand economy is evolving broadly as anticipated. Activity continues to slow in parts of the economy that are more sensitive to interest rates. Labour shortages are easing as overall demand softens and immigration adds to labour resources. Headline inflation and inflation expectations have declined, but measures of core inflation remain too high.

Globally, economic growth remains below trend and headline inflation has eased for most of our trading partners. Core inflation remains high in many countries. Weakening global economic growth is putting downward pressure on New Zealand export prices.

The imbalance between demand and supply is moderating in the New Zealand economy. However, a prolonged period of subdued spending growth is still required to better match the supply capacity of the economy and reduce inflation pressure.

In the near term, there is a risk that activity and inflation measures do not slow as much as expected. Over the medium-term, a greater slowdown in global economic demand, particularly in China, could weigh more on commodity prices and overall New Zealand export revenue.

The Committee is confident that with interest rates remaining at a restrictive level for some time, consumer price inflation will return to within its target range of 1 to 3% per annum, while supporting maximum sustainable employment.

Summary record of meeting

The Monetary Policy Committee discussed recent developments in the New Zealand economy. The Committee agreed that monetary conditions are restricting spending and reducing inflationary pressure as anticipated. While supply constraints in the economy continue to ease, inflation remains too high. Spending needs to remain subdued to better match the economy's ability to supply goods and services, so that consumer price inflation returns to its target range.

Global economic growth remains below trend for most of our trading partners. While global growth was resilient across the first half of the year this is beginning to fade, particularly in China. Globally, headline inflation has declined but core inflation remains high in many countries. The Committee noted that regional divergences in the moderation of core inflation are beginning to emerge.

New Zealand's export volumes over the last quarter were more resilient than expected due to favourable agricultural growing conditions in some regions. However, export revenues are expected to ease, in line with weakening global demand. A decline in global commodity prices has seen prices for New Zealand's exports moderate.

The Committee noted that tight monetary conditions continue to constrain domestic spending. The slowdown in economic activity is most notable in the parts of the economy that are more sensitive to interest rates. The Committee judged that with monetary conditions remaining restrictive, they expect to see further declines in consumption per capita and for GDP growth to be subdued over coming quarters.

Annual CPI inflation declined to 6.0% in the June quarter, with tradables inflation declining more than non-tradables inflation. Most measures of inflation expectations have declined alongside the fall in headline inflation. However, measures of core inflation remain near their recent highs.

The Committee discussed the labour market and agreed that capacity pressures have begun to ease. Recent net immigration has increased labour supply, helping to alleviate some labour market shortages. Employment growth remains resilient. The Committee noted that most measures of annual wage inflation have begun to ease.

The Committee noted that the estimate of the nominal neutral OCR has increased by 25 basis points to 2.25% within the projections, consistent with the Reserve Bank's indicator suite. The Committee agreed that the current level of the OCR remains contractionary and is constraining domestic spending as needed.

The Committee discussed the increase in the current account deficit and noted that this is primarily due to reduced services exports stemming from the COVID-19 pandemic as well as excess domestic demand. The current account deficit is expected to steadily narrow. Members noted that net foreign liabilities have declined over recent years and that risks associated with funding the deficit were low, as most foreign debt is hedged against foreign exchange risk.

The Committee discussed the recent strong growth in net immigration. The overall impact on demand and inflation pressure remains uncertain. Members noted that the current increase in net immigration may be less inflationary than previous increases, due to both changes to the composition of migrants and in the context of a tight domestic labour market.

The Committee noted that house prices appear to have stabilised. Members agreed that the current projection for house prices was reasonably balanced, remaining around estimates of sustainable levels. The Committee agreed that house price changes have an impact on household wealth. However, members agreed the willingness to consume out of wealth can vary and may be lower in the current context of high debt servicing costs.

The Committee discussed the balance of risks for inflation, output, and employment. Members noted that current projections are for subdued GDP growth, rather than a sharp downturn.

In discussing near-term risks, members considered upside risks to activity and inflation. Members discussed the impact of recent administered price increases – for example, council rates and excise tax – on headline inflation for the September quarter and noted that this could pose a risk to inflation expectations. Members also discussed risks around a slower easing in the labour market resulting in wage inflation taking longer to decline.

The Committee noted that the projections for government expenditure and revenue are predicated on Budget 2023 forecasts. Overall, real government consumption and investment spending as a share of potential GDP is projected to decline over the forecast horizon.

Over the medium term, the Committee discussed risks around the outlook for global growth and judged that these were skewed to the downside. A greater slowdown in global growth would likely see a fall in import prices. Members noted that weaker global demand, particularly from China, could weigh further on commodity prices and therefore on export revenues.

Members also discussed the risks around the lagged effect of previous monetary tightening on households and businesses. The average mortgage rate on outstanding loans is expected to rise from around 5% to near 6% by early 2024, and debt servicing costs as a share of income are still increasing.

Members discussed the risk to those parts of the economy most exposed to lower commodity or asset prices. The Committee agreed that the slowdown in economic activity will not be even across sectors of the economy, due to global factors and the varied impact of high domestic interest rates. In particular, the Committee noted that pockets of stress were beginning to emerge for some households, and the commercial property, agriculture, and construction sectors.

The Committee agreed that in the current circumstances, there is no material trade-off between meeting the Committee's inflation and employment objectives and maintaining the stability of the financial system. Members noted that debt levels are high in some parts of the economy and debt servicing costs have increased. While broad indicators of stress have increased, non-performing loans remain at low levels.

In discussing their Remit objectives, the Committee noted inflation is still expected to decline within the target band by the second half of 2024. The Committee agreed that the risks around the inflation projection remain balanced. Employment is above its maximum sustainable level, however, recent indicators show that labour market pressures continue to ease.

The Monetary Policy Committee discussed the appropriate stance of monetary policy. The Committee agreed that interest rates still need to remain at a restrictive level for the foreseeable future, to ensure annual consumer price inflation returns to the 1 to 3% target range while supporting maximum sustainable employment.

On Wednesday 16 August, the Committee reached a consensus to maintain the Official Cash Rate at 5.50%.

Attendees:

Reserve Bank members of MPC: Adrian Orr, Karen Silk, Christian Hawkesby, Paul Conway
External MPC members: Bob Buckle, Peter Harris, Caroline Saunders
Treasury Observer: Dominick Stephens

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