Research

Economy Watch

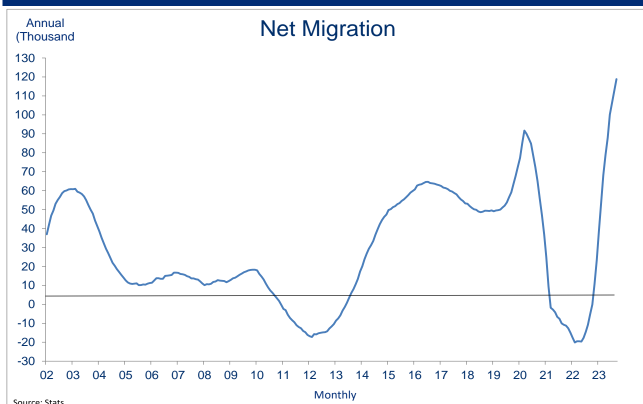
29 November 2023

More migration, higher rates!

- **Cash rate unchanged at 5.5%**
- **RBNZ more hawkish than we expected**
- **Bank raise rate track, we delay expected first cut**
- **Migration and inflation expectations major focal points**
- **Market watches in disbelief**

The RBNZ appears to have been spooked by soaring net immigration. It seems the expectation of rising demand and house prices on CPI inflation has dominated the Monetary Policy Committee's thinking, as opposed to focussing on the disinflation being created by a rapidly easing labour market.

Migration drives inflation?



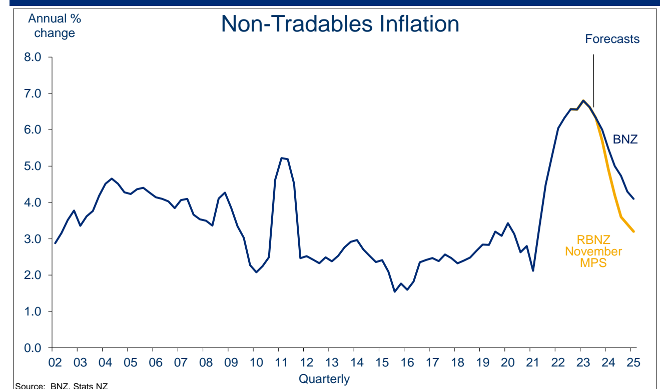
In what was an outrightly hawkish statement, the RBNZ has now effectively put the odds of another rate hike at greater than even. This is higher than the implied probability presented in its August Monetary Policy Statement. Governor Orr says you can't deduce a probability from the change in the Bank's rate track but one has to read something from a shift of its modelled peak from 5.59% to 5.69%.

In a surprise move, to us at least, the Bank largely dismissed recent data showing inflation coming in lower than expected and the labour market being weaker.

With regard to inflation, the RBNZ notes that non-tradables inflation is still elevated and that the drop in inflation was all about tradables. It also noted that inflation expectations were not behaving in the manner that they would have liked.

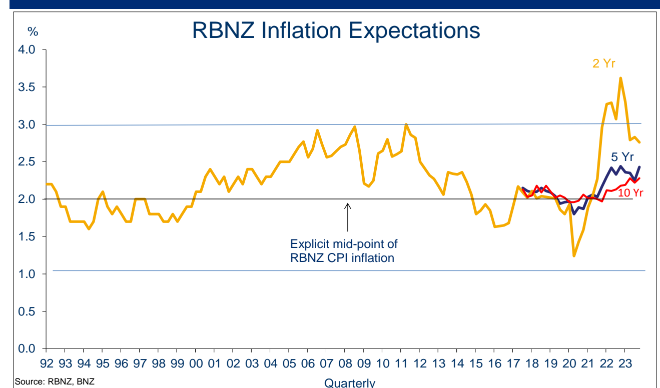
While we do not disagree with this, we are quick to note that non-tradables inflation was bang on the RBNZ's forecasts. It has, however, raised its projections for this measure and it's the forecasts that matter more. Be that as it may, note that much of the pressure on non-tradables comes from rates, insurance and rents. Rents are being affected by rates and insurance as well as slowing construction and rising immigration. A lot of this inflation represents a relative price shift. Alas, no amount of monetary tightening will reverse the factors that are the predominant drivers of inflation in these sectors.

What's the worry



As for inflation expectations Governor Orr made a big deal about the fact that ten year inflation expectations rose to 2.28% from 2.22%. He saw this as being an assault on the RBNZ's credibility. After all this is just 28 basis points away from the RBNZ's target. It hardly seems disastrous to us. The general trend in inflation expectations across the economy is down.

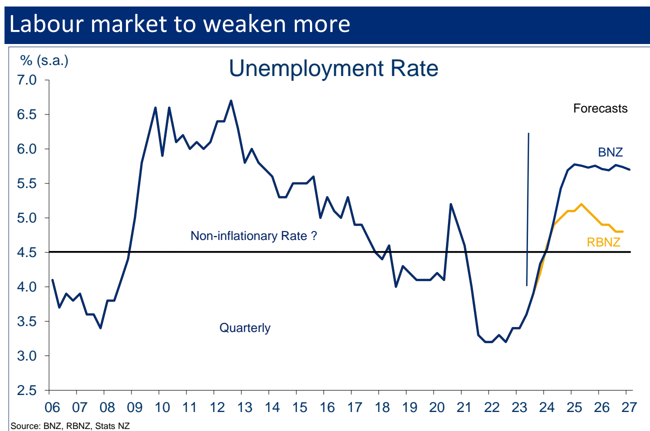
Problem or not?



In our opinion, labour market conditions have eased aggressively and highly likely more so than the RBNZ had

anticipated. Yet the Monetary Policy Statement says very little about this instead focusing on the fact that the economy is still operating with employment remaining above its maximum sustainable level. It is our strong view this will not be the case for much longer and we believe the labour market will soften more than the RBNZ currently assumes. In particular, we forecast the unemployment rate to increase faster than the RBNZ expects as the supply of labour continues rising while demand drops.

Labour market to weaken more



The RBNZ played a straight bat with regard to fiscal policy and the change in government by formally including the Pre Election Fiscal Update (PREFU) numbers into its forecasts. This is the traditional approach. According to the RBNZ, the PREFU had more stimulatory government settings embedded in it than did the Budget so this did put upward pressure on activity and prices. Orr, in his post match news conference, did specifically highlight future government policy will matter and the RBNZ did say that "With a new Government settling in, the fiscal outlook is highly uncertain." We wonder how this uncertainty was treated when deliberations were being made on today's rate set.

One of the reasons the RBNZ might use for suggesting a higher rate track is that it revised higher its neutral rate expectation to 2.5% from 2.25%. But even with the higher reading, this still leaves us with the cash rate 300 basis points above neutral. Does it really need to be any higher than this?

Interestingly, the RBNZ notes it has updated its estimates of the time it takes for changes in the OCR to have their peak impact on inflation to six to nine quarters. This is not news. It's always been widely accepted that it takes 18 months to 2 years for monetary policy to work.

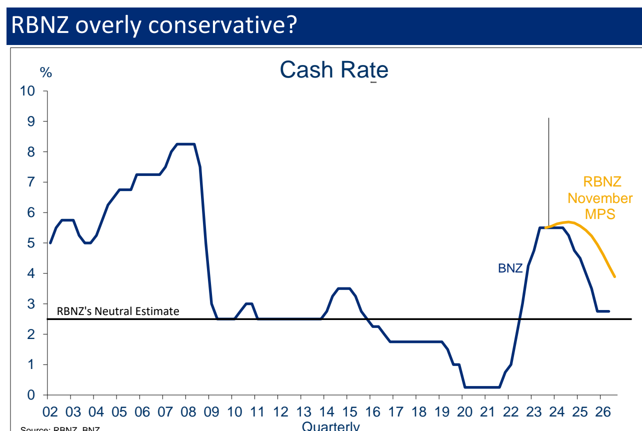
The question that this analysis leaves, though, is why do interest rates need to be above neutral for the entire forecast period if inflation has already hit the target mid point in September 2025?

Whether, we agree with the RBNZ's approach or not is largely irrelevant. If the Reserve Bank means what it says, and we have no reason to doubt this, then we also have to accept the chance of a further rate hike is very real.

However, we still can't bring ourselves to formally build in a rate hike into our own forecasts. In short, we think economic growth will end up below RBNZ forecasts, Q4 CPI inflation will be lower than expected and the labour market will eventually be weaker than the Bank anticipates.

But it will take time for all this to play out and it is clear the RBNZ needs to see the whites in the eyes of inflation success before it contemplates easing. Indeed, its first published easing waits until inflation is so close to 2.0% that it doesn't matter – namely the June quarter 2025. On this basis we have decided to move our first rate cut back to August 2024 from May 2024.

RBNZ overly conservative?



Reading between the lines, we can't help but think one of the reasons the RBNZ adopted such a hawkish stance is that it was concerned financial markets were pricing in three rate cuts in 2024. It would have feared that if it displayed any overt sign of satisfaction it was winning the battle against inflation that it would result in even more aggressive rate cut pricing by markets. We warned that the Reserve Bank would be nervous about this but, perhaps, we underestimated just how nervous it is.

This being so, we wonder what the RBNZ's thinking about the market reaction to today's release might be. In short, it would seem investors don't believe what the RBNZ is saying. Two rate cuts are still priced for next year. Sure, it was three but two is two more than the RBNZ would be happy with. In large part this will reflect the growing view that the global monetary cycle is turning and that New Zealand will have to follow suit.

Householders and businesses need to be aware that current lending rates are predicated on the market expectation that the cash rate falls. If this is priced out, as the RBNZ desires, then lending rates will again rise.

One thing that did move was the NZD which is up almost 50 basis points to 71.7 on a trade weighted index basis. This is almost 1.5% above the level the RBNZ has assumed in its forecasts. The good news is that this alone should knock around 0.2 percentage points from the Bank's annual CPI inflation forecasts.

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Full text from Monetary Policy Statement

Interest rates are restricting spending in the economy and consumer price inflation is declining, as is necessary to meet the Committee's Remit. However, inflation remains too high, and the Committee remains wary of ongoing inflationary pressures.

Internationally, economic growth has been stronger than was expected at the start of this year but remains below trend and is likely to slow further. This subdued growth outlook will continue to restrain New Zealand's export revenues.

In New Zealand, demand growth has eased, but by less than anticipated over the first half of 2023 in part due to strong population growth. The OCR will need to stay restrictive, so demand growth remains subdued, and inflation returns to the 1 to 3 percent target range.

Wage growth has eased from recent peaks. Demand for labour is softening, with job advertisements now below pre-COVID-19 levels. At the same time, strong inward migration is increasing the population and adding to labour supply.

While population growth has eased supply constraints, the effects on aggregate demand are becoming apparent. This is increasing the risk of inflation remaining above target.

The Committee is confident that the current level of the OCR is restricting demand. However, ongoing excess demand and inflationary pressures are of concern, given the elevated level of core inflation. If inflationary pressures were to be stronger than anticipated, the OCR would likely need to increase further.

The Monetary Policy Committee agreed that interest rates will need to remain at a restrictive level for a sustained period of time, so that consumer price inflation returns to target and to support 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. Supply constraints in the economy continue to ease and demand growth is slowing, but to a lesser extent than expected. Inflation remains too high and inflationary pressures continue to emerge. Further slowing in spending growth is needed to reduce demand toward the economy's ability to supply goods and services, to ensure that consumer price inflation returns to its target range.

Global economic growth remains below trend as high interest rates weigh on demand. Easing global demand is placing downward pressure on New Zealand exports, and export revenues are lower than in recent years. However, global prices for some products, such as dairy, have stabilised in recent months. Members noted that to date, global growth has been stronger than was expected at the start of this year, supported by sustained strength in the US economy and a recent lift in economic activity in China. However, going forward, subdued global growth is expected to restrain demand and prices for New Zealand's exports over the medium term.

The Committee discussed international inflation trends. Globally, headline inflation continues to fall, but there are differences in both the timing and magnitude of these declines across countries. Housing rent inflation is an important source of difference in services inflation across countries, with greater upward pressure in economies experiencing high net immigration, such as New Zealand and Australia.

In discussing global financial conditions, the Committee noted that long-term interest rates for government debt have increased, largely in response to the rising volume of public debt. More recently, interest rates have decreased as financial markets anticipate the end of the phase of monetary policy tightening by major central banks. Members also noted that most major central banks have indicated that they intend to retain current restrictive policy rates for longer, and are willing to tighten further, if required.

The Committee discussed recent domestic economic developments. While growth in parts of the economy is slowing, there has been less of a decline in aggregate demand growth than expected earlier in the year. As was noted in the October Review, GDP growth in the second quarter of 2023 was higher than expected while growth in the first quarter was revised up. Consumer spending growth is broadly easing, but some areas of services spending remain more resilient. On an aggregate level, consumption is being supported by the strong growth in population, whereas on a per capita basis, consumption is declining.

Members noted that net immigration has been higher than previously assumed. This has increased the supply of workers into a tight labour market. However, the demand-side effects are becoming apparent. Strong population growth has contributed to an increase in housing rents. Rent increases, and any increases in construction costs in response to greater housing

requirements, affect inflation directly, as rental prices and construction costs are accounted for in the consumer price index. Members noted that the outlook for residential investment was currently muted, despite the surge in population growth.

House prices have stabilised after earlier declines, with strong population growth and increased nominal disposable incomes offsetting the effect of higher debt servicing costs. House price increases affect inflationary pressures indirectly, via higher household wealth and an associated increase in consumption. Some members considered that the willingness of households to consume out of wealth may be lower given recent house price falls, higher debt servicing costs, and a softening labour market. Other members considered that there may be upside risks to house prices, and therefore consumption, given the anticipated decline in residential investment.

Annual headline inflation was lower than expected in the September 2023 quarter. This was accounted for by lower inflation for tradable goods and services. Members noted that tradable inflation can be volatile and cannot be relied upon to achieve their inflation target. Non-tradable inflation is easing only gradually and, while all measures of core inflation have declined, they are still elevated. Short-term inflation expectations have declined, and members expect this to continue as headline inflation moves lower. Some members were concerned that 2-year inflation expectations were not declining particularly quickly and that longer-term inflation expectations had also increased. Other members were less concerned as they viewed longer-term inflation expectations as still close to the target midpoint.

In discussing the labour market, members noted that the underutilisation rate and unemployment rate both increased in the September 2023 quarter. Population growth has increased labour supply, as seen in declines in surveyed measures of labour shortages. As economic activity slows, labour demand is also declining, with job advertisements falling to below pre-COVID-19 levels. Wage inflation has eased. Members noted that whilst pressures in the labour market are easing, it is still tight, and employment remains above its maximum sustainable level.

At the time of the October Review, members had noted updates in the Pre-election Economic and Fiscal Update 2023 (PREFU). Specifically, while total government spending as a share of potential GDP is still forecast to decline, this was now by less than previously expected. The PREFU included a material increase in government investment over the medium term, linked to infrastructure requirements.

Members agreed that population growth and government investment would both likely support aggregate supply in the economy. However, they noted that in the short to medium term, demand could only sustainably grow at the economy's production potential without adding to inflationary pressure. The current context is that aggregate demand has been greater than the economy's ability to supply goods and services, creating inflationary pressure. While the economy is moving back into balance, ensuring that demand remains contained will make the task of returning inflation to target much easier.

The Committee noted that the estimate of the long-run nominal neutral OCR has increased by 25 basis points to 2.50 pecrent within the economic projections, consistent with the Reserve Bank's indicator suite. The long-run nominal neutral rate impacts the central economic projections 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 domestic financial conditions. Credit demand remains subdued as higher interest rates and a slowing economy reduce the ability and willingness of businesses and households to borrow. Mortgage rates have continued to increase, as expected. Members noted that the average rate on outstanding mortgages is expected to increase from 5.4 percent currently to 6.4 percent by mid-2024. The share of disposable income going to debt servicing for households with a mortgage is expected to increase from 15 percent currently to 19 percent.

The Committee discussed the expected evolution of retail interest rates, given ongoing changes in bank funding. Term deposit rates and volumes have increased. Higher term deposit rates are now contributing to ongoing increases in mortgage rates. As competition for term deposits continues, the margin between mortgage rates and wholesale interest rates is expected to return to more historically normal levels. Members agreed this expectation was consistent both with their previous discussions around future changes to retail interest rates, and with assumptions in the economic projection.

The Committee discussed the balance of risks for inflation, output, and employment. Members agreed that while the risk profile remained broadly similar to that discussed at the time of the August Statement, some of the short-term upside

risks to activity appear to have eventuated and have therefore been incorporated in the central economic projection. In considering risks, members also specifically discussed two scenarios.

The first scenario was one of persistent domestic demand strength supported by strong population growth, with increases in rents and aggregate consumption feeding into greater inflationary pressure and higher house prices. The second scenario considered a larger global economic slowdown, with growth below trend for longer than currently anticipated. A greater slowdown in global growth would see a fall in the price of imports and further reduce goods export prices and export volumes.

Given the current high level of core inflation, members agreed that there was an asymmetry in the distribution of risks to the outlook for monetary policy across the two scenarios. A global slowdown would likely unwind the additional inflationary pressure that has recently been observed, whereas further domestic demand strength would likely necessitate additional monetary tightening. Some members noted that inflation has now been above target for some time, and that there should be a low tolerance for any increase in the time to return inflation to target.

The Committee noted that the incoming Government’s policy programme will have implications for economic activity and inflation. Members agreed that this would be assessed as policies are formally incorporated into the Treasury’s official forecasts.

The Committee discussed the backdrop of heightened geopolitical tension and risk of spillovers to the global economy. Members noted that whilst they remain attentive to global developments, they will respond to shocks if and when they eventuate. The Committee also discussed the outlook for China and noted that while economic data over recent months have improved, structural challenges facing the Chinese economy remain concerning for long-term growth prospects. Potential growth is slowing, partly due to demographic trends, but also due to substantial declines in productivity growth. High levels of debt, particularly in the property sector, and weak demand remain the most acute downside risks.

Members were cognisant of the likelihood of an El Niño climate pattern in coming months. They noted that the scale of potential impact is highly uncertain and depends on the timing and location of any droughts. There may be differentiated impacts for different agricultural commodities. No specific drought impacts have been incorporated in the economic projection and members agreed they would continue to closely monitor the evolution of El Niño over coming months.

The Committee agreed that in the current circumstances, there is no material trade-off between meeting their inflation and employment objectives and maintaining stability of the financial system. Members noted that slowing economic activity is not being experienced evenly across the economy. The commercial property and agricultural sectors are starting to experience challenges and may be vulnerable. For highly-indebted households, pockets of stress are likely to grow as debt servicing burdens increase.

In discussing their Remit objectives, the Committee noted inflation is still expected to decline to within the target band by the second half of 2024. Pressure in the labour market is easing, although employment remains above its maximum sustainable level. Members agreed that monetary policy was supportive of sustainable house prices.

In discussing the appropriate stance of monetary policy, members agreed they remain confident that monetary policy is restricting demand. Nevertheless, ongoing excess demand and inflationary pressures were of concern, given high core inflation. Members discussed the possibility of the need for increases to the OCR. Members agreed that with interest rates already restrictive, it was appropriate to wait for further data and information to observe the speed and extent of easing in capacity pressures in the economy.

The Committee agreed that interest rates will need to remain at a restrictive level for longer, to ensure annual consumer price inflation returns to the 1 to 3 percent target range and to support maximum sustainable employment. On Wednesday 29 November, the Committee reached a consensus to maintain the Official Cash Rate at 5.50 percent.

Attendees

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

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