Research

Economy Watch

28 February 2024

RBNZ Holds

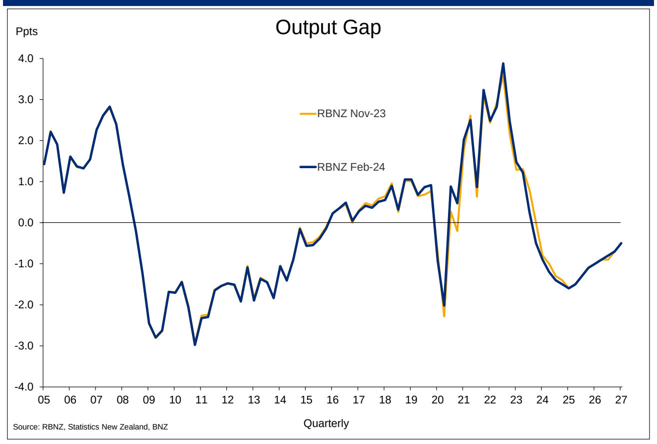
- **RBNZ holds cash rate at 5.50%**
- **Maintains tightening bias, but watered down**
- **Bank remains alert to cost pressure spillover**
- **Rate track consistent with rates cuts from H1 2025**
- **We maintain our view of cuts starting later this year**

The RBNZ held the cash rate at 5.50% this afternoon. The Bank also maintained its tightening bias, albeit somewhat watered down from its November statement.

This was very close to our expectations as detailed in our MPS preview. Our broad assessment is that the labour market is easing, spare capacity is growing, and inflation, both headline and core, is falling. And established measures of inflation expectations are falling. Hence there is no need to lift rates further.

It seems the RBNZ shares this general view. The Bank noted core inflation and most measures of inflation expectations have declined. The Bank acknowledged the starting point to capacity pressure was lower than its previous estimate, although only slightly, which is a nod to the recent GDP undershoot (including revisions) that we have previously highlighted.

Spare Capacity Opening



On inflation expectations, the central bank stated that most measures have declined. This is important as the Bank previously felt that its credibility was being questioned when inflation expectations were pushing higher.

The RBNZ retention of a tightening bias is illustrated by its forward OCR track still showing some chance of a hike. The forward track doesn't look much different in the big picture, but the eagle eyes will see the peak has edged somewhat lower to 5.60% in Q3 2024 now, from 5.69% at the same point in its previous projections. We see this as the Bank maintaining a degree of optionality, rather than any real intent to hike. Of course, that all depends on the data. It is important to note that the Bank's rate track now implies a first rate reduction in H1 2025, which is a bringing forward from the previous projection.

Maintenance of a tightening bias for the time being is consistent with the Bank remaining alert to various inflation risks, including potential spillover from relative cost pressures. Fair enough at this juncture, we can understand that. The Bank stated that inflation remains above the 1 to 3 percent target band, limiting the Committee's ability to tolerate upside inflation surprises. But this has a whiff of a change from the previous no tolerance to upside surprises, to now limited tolerance. Perhaps most importantly, the Bank now sees the risks to the inflation outlook as more balanced.

Interestingly, the central bank's assessment on immigration has become more balanced regards its influence on inflationary pressures – citing both the supply and demand influences. It seemed more concerned about the inflationary consequences last time around.

On the global front the Bank noted weakness in the outlook for China's economy and the general risk to global growth, as central banks may need to keep policy rates at restrictive levels for longer than currently reflected in market pricing.

Overall, we broadly concur with the RBNZ's assessment of the state of play. We thought the balance of data since the previous statement had not been to the upside. That is why we thought the RBNZ would hold today, and aggressively maintaining tight monetary conditions. That is exactly what the Bank has done.

It is interesting that there seemed no discussion in the Committee on any dissent regards the decision. In fact, RBNZ Governor Orr said in the press conference that there was strong consensus to hold. Governor Orr noted in the press conference that there was some discussion of hike today, and certainly not a cut. That fits with the balance of risk that we saw ahead of the meeting.

The statement was certainly more dovish than the market was expecting, with the NZD dropping around 50pips and wholesale interest rates falling across the curve post announcement, with a steepening bias as short end rates fell more than longer term rates. The market has essentially taken out the chance of any further hikes and sees at least one cut by the end of the year.

None of the above changes our view of the world. We maintain our forecast that the RBNZ is on hold for the time being and we continue to expect the first rate cut later this year.

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Full text from Monetary Policy Statement

Over the past year or so, the New Zealand economy has evolved broadly as anticipated by the Committee. Core inflation and most measures of inflation expectations have declined, and the risks to the inflation outlook have become more balanced. However, headline inflation remains above the 1 to 3 percent target band, limiting the Committee's ability to tolerate upside inflation surprises.

Restrictive monetary policy and lower global growth have contributed to aggregate demand slowing to better match the supply capacity of the New Zealand economy. With high immigration and weaker demand growth, capacity constraints in the New Zealand labour market have eased.

However, recent high population growth is supporting aggregate spending, as evident in upward pressure on dwelling rents, for example.

Internationally, global economic growth remains below trend and is expected to slow further during 2024. This subdued environment will support a further moderation in New Zealand's import price inflation.

The outlook for the China economy remains particularly weak relative to recent historical norms, with structural factors constraining long-term growth. A more general risk to global growth is that central banks may need to keep policy interest rates at restrictive levels for longer than currently reflected by financial market pricing, to ensure that inflation targets are met.

Heightened geopolitical and climate conditions remain a risk for inflation. The recent rise in global shipping costs is one manifestation of these risks. The Committee remains alert to these relative cost pressures and will act to limit spillovers into general inflation if necessary.

The Committee remains confident that the current level of the OCR is restricting demand. However, a sustained decline in capacity pressures in the New Zealand economy is required to ensure that headline inflation returns to the 1 to 3 percent target. The OCR needs to remain at a restrictive level for a sustained period of time to ensure this occurs.

Summary record of meeting

The Monetary Policy Committee discussed recent developments in the New Zealand and global economies. The Committee agreed that the New Zealand economy has evolved largely as expected over the past year or so. Headline inflation, core inflation and most measures of inflation expectations are continuing to decline. However, inflation remains above the Committee's target range. Restrictive monetary policy is contributing to an easing in capacity pressures. Monetary policy needs to remain restrictive to ensure that inflation returns to target.

Global growth was below trend last year. New Zealand's trading partner growth is expected to slow in 2024. This will support a further drop in global inflation and New Zealand import price inflation. Measures of headline and core inflation continue to fall among our trading partners. Global supply disruptions have eased, and restrictive monetary conditions continue to contribute to reduced demand. Although prices of New Zealand's exports have recently increased, continued below trend global growth is expected to limit the scale of further increases.

In discussing global financial conditions, the Committee noted that long-term wholesale interest rates have fallen since the November Statement. This has put downward pressure on domestic wholesale interest rates. Globally, central banks have generally kept policy interest rates steady at restrictive levels, and financial market participants have shifted their focus towards the timing and degree of potential policy rate cuts expected this year.

The Committee discussed recent domestic economic developments. Capacity pressures have eased significantly over the past year. Aggregate demand is now better matched with the supply capacity of the economy. A combination of lower demand and growing supply is bringing domestic inflation down. Below-trend global growth and slightly lower prices for our imported goods and services have also helped to lower headline inflation over recent quarters.

Members noted that gross domestic product (GDP) declined by 0.3 percent in the September 2023 quarter. This was weaker than projected in the November Statement. Revisions to GDP going back several years imply that potential GDP –

the amount of production that the economy can supply sustainably – has also been lower than previously assumed. On net, these factors imply that the starting point for capacity pressures in the New Zealand economy is only slightly lower than previously assumed.

The Committee discussed the low rate of productivity growth implied by recent GDP data. If sustained, lower productivity would contribute to a lower rate of potential growth of the economy. This would limit the rate at which the economy can sustainably grow without generating inflation.

Members noted that strong net immigration is contributing to demand, with the recent increase in rent inflation an example. However, net immigration also means that there are more workers available, boosting the supply capacity of the economy. Businesses are reporting that it has become much easier to find workers. In general, capacity pressures in the labour market have eased.

Members discussed the recent increases in global dairy prices and lower prices for our imported goods and services. These developments have resulted in an improvement in New Zealand's terms of trade, which will increase primary sector incomes and domestic activity. Recent attacks on shipping in the Red Sea and drought near the Panama Canal are creating delays in getting exports to global markets and increasing global shipping costs. These rising costs could decrease exporter profitability and will likely feed into global and imported inflation if sustained.

Members noted that annual house price inflation remains modest. There is heightened uncertainty around the outlook for house prices. This reflects continued restrictive interest rates, the scale of decline in residential investment, and the net economic effects of currently strong net immigration.

The Committee discussed recent inflation outturns. Annual consumer price index (CPI) inflation declined to 4.7 percent in the December 2023 quarter. While this is much lower than its peak of 7.3 percent in mid-2022, it remains above the Committee's 1 to 3 percent target band. Inflation was lower than expected in the December 2023 quarter. Both tradable and non-tradables inflation fell, with tradables inflation falling by more than expected. Recent drops in core inflation and business inflation expectations are encouraging, but they remain above the 2 percent mid-point of the Committee's target band.

Members discussed the lags of monetary policy and how the economy has evolved relative to the series of projections made over the last year or so. In general, the economy has evolved as expected. Headline inflation is slightly lower than had been assumed, reflecting lower-than-expected tradables inflation. The unemployment rate is lower than projected, but wage inflation has been more subdued. The current assessment of capacity pressures is consistent with previous projections. These past forecasts and outcomes are consistent with the assessment that monetary policy settings have constrained demand broadly as expected.

The Committee discussed the implications of fiscal policy for the economic outlook and the potential impacts of new proposed policies. The Committee noted that the central projection for government spending is based on Treasury's published forecasts in the Half Year Economic and Fiscal Update (HYEFU) 2023. Government expenditure is projected to decline as a share of the economy in coming years. There is uncertainty over the timing and scale of new fiscal policy initiatives and the implications for monetary policy. The Committee will take any new fiscal initiatives into account when Budget 2024 is released in May.

The Committee discussed the recent publication of the Selected Price Indices from Stats NZ. The Committee welcomed the publication of these monthly indicators. The Committee also noted that more frequent publication of inflation figures and more regular reweighting of the CPI would be consistent with global practice. Such changes would support the Committee in assessing the current state of the economy, particularly in periods of heightened economic uncertainty and volatility.

Members discussed recent developments in domestic financial conditions. Overall, credit growth remains subdued. Financial conditions have become less restrictive since the November Statement. Mortgage rates have dipped slightly at most tenors and term deposit rates have fallen at tenors of more than six months. The margin between mortgage rates and wholesale interest rates is expected to return to more historically normal levels, as competition for term deposits continues and funding conditions for banks continue to tighten. This is expected to see mortgage rates hold up relative to wholesale interest rates.

The Committee discussed the key risks to the outlook for inflation. Members noted that overall, risks to the outlook for inflation were more balanced than at the time of the November 2023 Statement. However, from a monetary policy perspective, there remains less capacity to absorb upside inflation surprises, relative to downside surprises.

The Committee discussed the outlook for China, given its significance for the global economy and for New Zealand export and import prices. Structural challenges facing the economy in China remain concerning for long-term growth. 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.

The Committee discussed the backdrop of heightened geopolitical tension and risk of spillovers to the global economy. The current rise in global shipping costs is a realisation of these spillovers. Although higher shipping costs add to near-term inflation, projections assume that this relative price shock will reverse. There is considerable uncertainty over the size and duration of higher shipping costs. Consistent with the Remit, the Committee has therefore 'looked through' the first-round effect of recent higher shipping costs. Nevertheless, the Committee remains alert to these costs lasting longer than currently assumed. In that event, potential spillovers into general prices might require a monetary policy response.

Members also noted downside risks to the global growth outlook in advanced economies. Median analyst projections were for a steady decline in inflation, with global growth expected to track modestly below the growth rates seen in 2023. A more general risk to global growth is that central banks may need to keep policy interest rates at restrictive levels for longer than currently reflected in financial market pricing, to ensure that inflation targets are met.

Members noted that, while pressures in the New Zealand labour market are easing, some of the labour market capacity measures in our suite have eased only modestly. The Committee noted that variations in labour demand lag broader economic activity. Labour markets have evolved as expected, and a further moderation in labour market capacity pressure is expected. Capacity pressures in the labour market will need to continue to ease to meet our inflation mandate.

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 discussed the Bank's current public consultation on the proposed settings for Debt-to-Income (DTI) restrictions on borrowing. The Committee agreed that the DTI policy will further support financial stability through the interest rate cycle.

The Committee noted the recent changes to the Reserve Bank Act, Remit and MPC Charter. In line with the Charter, the Committee discussed the reasons inflation is outside of the target range, the expected time for inflation to return to the target midpoint of 2 percent, and the reasons for that timeframe.

The Committee noted that high inflation reflected:

- the significant disruption to global supply stemming from COVID-related responses from policy makers, businesses, and households.
- the substantial disruption to domestic production from COVID-related policies and a tight domestic labour market,
- the impact on demand of the easing in monetary policy and rise in fiscal spending undertaken at the beginning of the pandemic in the face of substantial uncertainty and significant downside risks to the economy, and,
- the increase in commodity prices and shipping costs resulting from war and geopolitical tension.

These factors are discussed in detail in the November 2022 Review and Assessment of the Formulation and Implementation of Monetary Policy.

The Committee noted that annual headline CPI inflation was expected to return to the target band in the September quarter this year and that monetary policy settings are consistent with annual headline CPI inflation returning to the 2 percent target midpoint later in 2025. The Committee noted, given current projections, there was limited tolerance to increase the time to the target mid-point. The Committee is conscious that the economy has limited capacity to absorb further upside inflation surprises, as this could risk a rise in inflation expectations and make it more difficult to get inflation back to target.

The Committee noted that aggregate demand is now better matched with the supply capacity of the economy. Policy settings consistent with the projected time for CPI inflation to return to the 2 percent target midpoint result in a period of excess supply. These ongoing restrictive monetary policy settings are necessary to guard against the risk of a rise in inflation expectations, 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 of time, to ensure annual consumer price inflation returns to the 1 to 3 percent target range. On Wednesday 28 February, the Committee reached a consensus to keep the Official Cash Rate at 5.50 percent.

Attendees

MPC members: Adrian Orr (Chair), Bob Buckle, Caroline Saunders, Christian Hawkesby, Karen Silk, Paul Conway, Peter Harris.
Treasury Observer: Dominick Stephens.
MPC Secretary: Adam Richardson

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