RBNZ OCR Call Change

18 January 2024

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Confused by acronyms or jargon? See a glossary here.

OCR call change – first cut now pencilled for August

Summary

- We now expect the RBNZ to deliver a steady sequence of 25bp OCR cuts starting in August, taking the OCR to 3.5% over 12 months. On our current forecasts, by the September quarter inflation is back in the band, unemployment has cracked the 5% mark and is still rising, and the output gap is deeply negative.
- August is not a strong conviction call by any means, and we currently see the risks as roughly balanced on whether the RBNZ starts cutting earlier or later than that. We would also note there's still a chance of a hike, either in February if we get ugly CPI details (not our expectation) or later in the year if inflation ultimately gets 'stuck'.
- Over the next six months, a strong supply recovery, previous weak GDP outturns and a deteriorating labour market should result in rapid disinflation for domestically driven CPI components. But with forward-looking activity indicators picking up, the RBNZ will remain wary of the risk of a second wind for the economy before persistent inflation is rooted out.
- We don't expect a lot of advance warning of policy easing. The sensible strategy for the RBNZ is to deny-deny-deny-cut, in a bid to avoid a premature easing in financial conditions that would be hard to haul a dovish market back from. Based on our macro view, markets are underestimating how long the "deny" part of that strategy will last.

The Reserve Bank's unexpectedly hawkish November Monetary Policy Statement just seven weeks ago warned the Committee would not hesitate to hike again if there were any more upside surprises on inflation – with an OCR forecast that, strictly speaking, implied the burden of proof was now on finding reasons *not* to hike. They forecast the first OCR cut in early 2025, in line with our own view at the time.

Since then, two significant pieces of data have been Q3 GDP (weak with downward revisions), and the NZIER's QSBO (mixed). CPI data is next week (see our Preview), which we expect to show a lower inflation starting point than the RBNZ expected, though with the news almost entirely in the less-important tradable part of the index.

Weighing up the recent mixed data, risks, our forecasts and strategic considerations, to be honest we find it difficult to come to a strongly held view on when the first OCR cut is likely to come. On balance, we've landed on August as most likely based on our macro forecasts, but we find it pretty easy to come up with plausible scenarios for either earlier or later than that, which we outline in this note. But let's kick off with a discussion of the main themes the RBNZ will be thinking about as the February MPS approaches.

The recession is easing capacity pressures

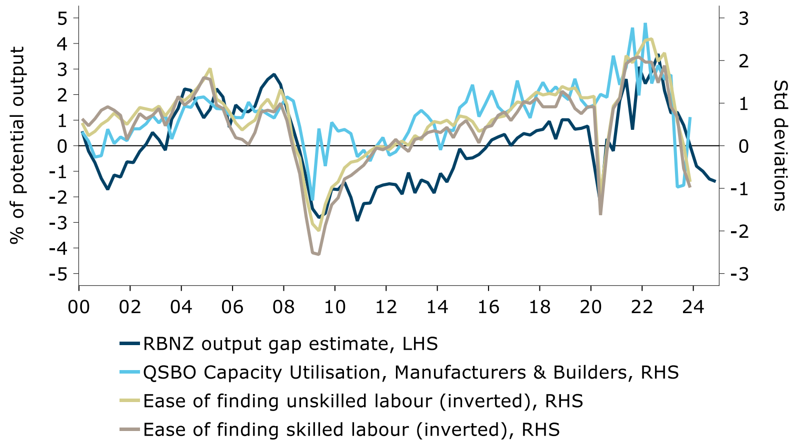
The RBNZ in November expressed frustration that “there has been less of a decline in aggregate demand growth than expected earlier in the year”. Not anymore. GDP data for Q3, released just before Christmas, came in considerably weaker than anyone expected, with meaningful downward revisions that changed the trajectory of real GDP from upward to flat (and downward on a per capita basis). The updated activity data is consistent with recession, and following the typical lags, the labour market data looks likely to soon be in the same boat.

“Normally”, a recession is a fast ticket to OCR cuts. But this recession is different in that it is deliberate. The RBNZ acknowledged in November 2022 that recession was the medicine to get inflation sustainably lower, and any doctor will tell you to finish the course of antibiotics. It remains unclear how long and deep the slowdown needs to be to do the job. The rebounding supply side of the economy is disinflationary, which is very helpful, but there are still some unwelcome signs of stickiness in non-tradable inflation that will keep the RBNZ wary.

Diagnosing the supply side of the economy, which is necessary to make a judgement on the degree of resource stretch (the “output gap”) and thus pipeline inflation pressure, is difficult. Net migration data is prone to significant revisions for around six months after release, and as for the capital stock or productivity, good luck to you. It makes intuitive sense that the influx of workers will have increased productivity as long-needed skills are finally available and capital can be fully utilised, but it’s hard to know where we’re at in that process, and that matters a lot.

GDP data is therefore just one input into estimating capacity pressures. The RBNZ looks at a wide range of direct indicators of the output gap, many of which come from the NZIER’s QSBO and Stats NZ’s labour market data. The QSBO was out this week and provided a mixed picture (see our Review), with some capacity indicators stronger and some weaker, but the most reliable (less volatile) measures such as the ease of finding labour would support the conclusion that resource stretch has eased a little more than the RBNZ thought in November (figure 1).

Figure 1. RBNZ estimate of the output gap and standardised QSBO capacity indicators



Source: NZIER, Macrobond, ANZ Research

It's worth noting in passing that the downward revisions to GDP were primarily to government consumption, exports and business investment. There was nothing to prompt a rethink by the RBNZ on where household consumption has been or is going, and that's the single most important sector in terms of monetary policy transmission.

The upshot: the RBNZ could conclude the weaker GDP data last year is a really big deal for the inflation outlook, or actually not that important, depending on how they diagnose the cause of the surprise. Did demand crash more quickly than expected, or were supply issues the main constraint, or some mix of the two? On balance, it's very likely that the RBNZ will revise down its estimate of upcoming inflation pressure to some extent, and in that context, the market reaction, to bring forward the timing of cuts, was entirely logical. But it's not a slam dunk for imminent cuts.

There's still a good case to be cautious

It would be easy to conclude that since the economy has been weaker than thought (and is outright dire in per capita terms, down 3% y/y), it is falling into a pit of despair that only OCR cuts can save it from. But it's entirely possible that the unexpected weakness in 2023 is a harbinger of unexpected *strength* in 2024, not further weakness, ie that it's partly a question of the timing of monetary policy impacts. Many forward-looking economic indicators are looking up, implying that the question of whether the RBNZ has done enough will not necessarily be resolved as quickly as the market expects.

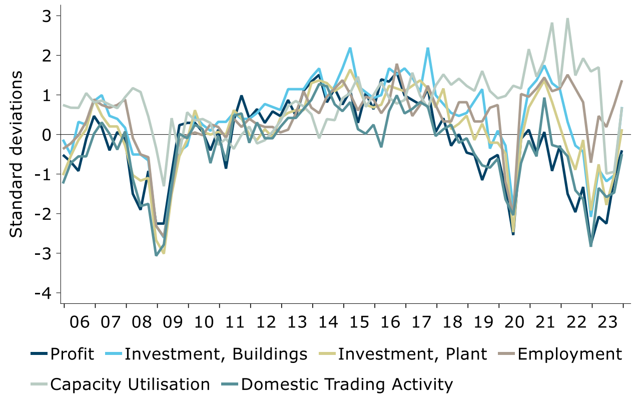
ANZBO forward-looking activity indicators have been rising for almost a year. They've been something of a lone voice, but they've now been corroborated by a strong lift in the NZIER QSBO equivalents.

Figures 2 and 3. Standardised forward-looking activity indicators

ANZBO (12m ahead)

Source: Macrobond, ANZ Research

NZIER QSBO (3m ahead)



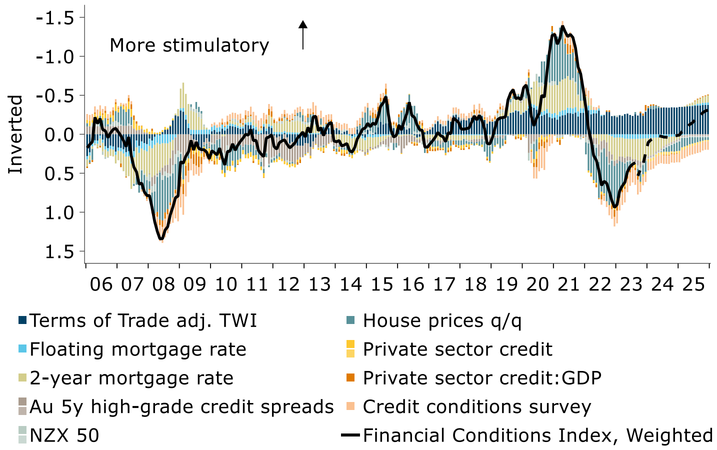
Source: NZIER, Macrobond, ANZ Research

Why might activity start to recover soon?

- **The lagged impacts of net migration are still working through**, including the impact on housing market activity. Housing market activity and pricing remain subdued, but the 4% increase we expect this year is nonetheless a very different environment from the relentless falls seen while the RBNZ was increasing the OCR.
- **Financial conditions are easing**, not least because house prices have bottomed, though the causality between housing and the broader economy runs both ways. Fixed mortgage rates are falling. The ANZ Financial Conditions Index (FCI) leads GDP by about nine months, and it

wasn't surprised by the GDP revisions or weak Q3 outturn. But it suggests a sharp V-shaped bounce from here (even before we update our mortgage rate forecasts for our updated lower OCR track).

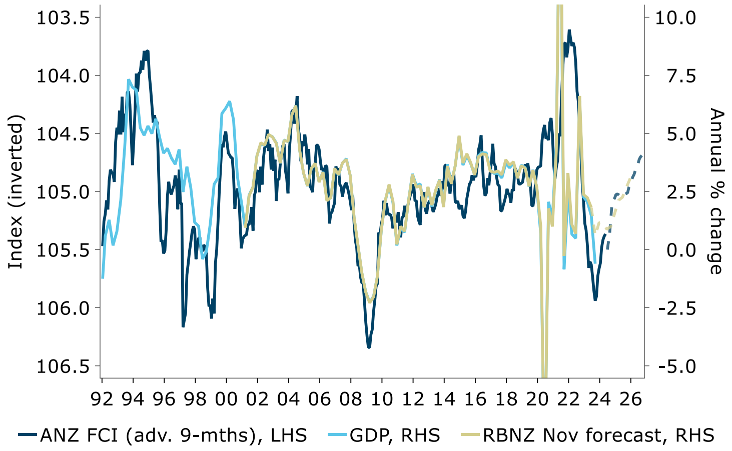
Figure 4. ANZ Financial Conditions Index



Source: Stats NZ, RBNZ, Bloomberg, Macrobond, ANZ Research

NB: Held constant at the last value in the projection: credit conditions, credit spreads and equities.

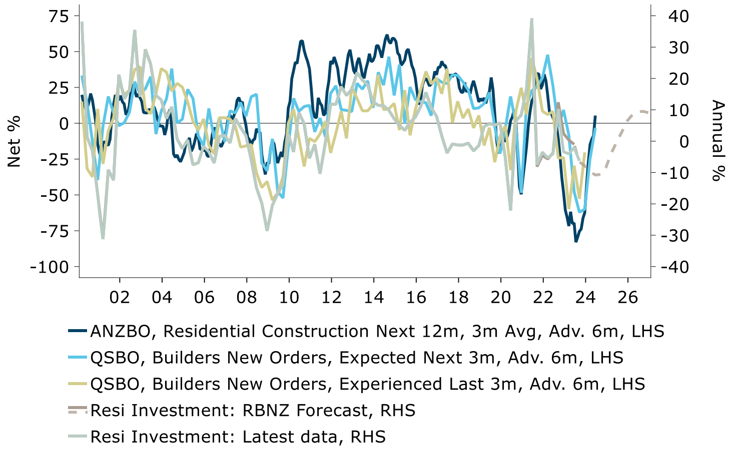
Figure 5. ANZ FCI vs. GDP actual and RBNZ forecast



Source: Stats NZ, RBNZ, S&P, REINZ, Bloomberg, Macrobond, ANZ Research

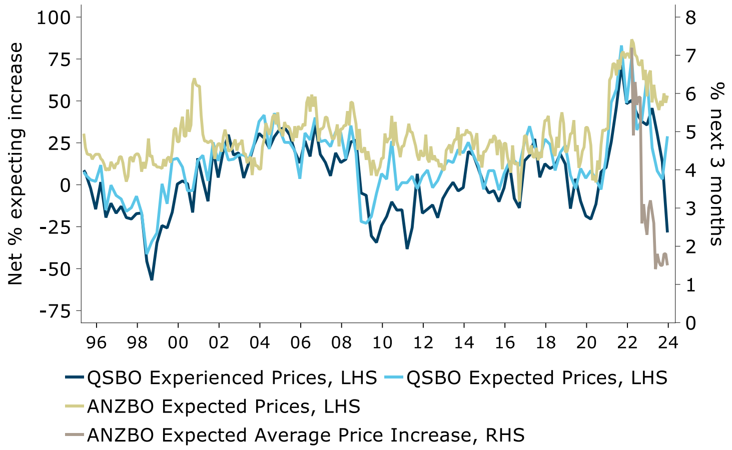
- **Construction may be about to bottom out.** The housing market rebound has been underwhelming, which suits the RBNZ just fine. However, both the ANZBO and the NZIER QSBO suggests that consents and construction activity could soon base. Compared to November, the RBNZ may be looking at a residential investment slowdown that is sharper but not as prolonged (figure 6), with unclear implications for the inflation outlook. Some comfort comes from the fact that construction cost indicators continue to ease markedly.

Figure 6. Surveyed construction indicators vs RBNZ residential investment forecast



Source: ANZ, RBNZ, Stats NZ, Macrobond, ANZ Research

Figure 7. Survey construction sector price indicators



Source: NZIER, Macrobond, ANZ Research

- **The tourism recovery continues.** The big wins are behind us (and weren't enough to save GDP last year!) but the likes of ANZ card spending shows tourism spending growth remains a bright spot. The RBNZ is already assuming a strong comeback, however, so there's not really much new news here.

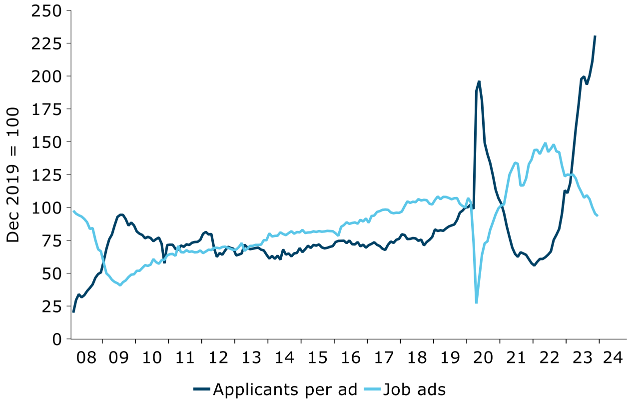
As we noted in our NZIER QSBO Review, improving demand is only inflationary to the extent that it isn't matched by growth in the supply side of the economy, and as noted above, the RBNZ is likely to revise its starting point estimate of the output gap and thus pipeline inflation pressures down. And the loosening labour market provides more evidence that the economy (and domestically generated inflation) is indeed cooling quickly enough to enable cuts this year. But those expecting an all-in pivot from the RBNZ will likely have to wait until some of the above questions about a potentially inflationary rebound are resolved – more runs on the board in terms of non-tradable inflation outcomes would be a great start. That could happen by May, but our current best guess is that it will take a little longer for the RBNZ to have the certainty it needs.

The labour market is cooling: tick

Given the economic weakness last year that has now been revealed, and the enormous surge of new workers via net migration, the labour market should be weakening. And it clearly is doing exactly that:

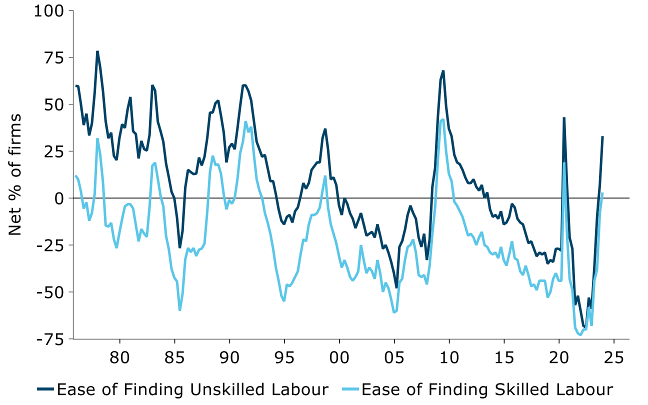
- Seek job ads are down 37% from their May 2022 peak and applicants per job ad have soared (figure 8).
- The unemployment rate has risen from its trough of 3.2% to 3.9% in Q3, with the more cycle-sensitive measures of unemployment (eg youth unemployment) already well off their lows (figure 9).
- In the NZIER QSBO, the ease of finding skilled and particularly, unskilled labour soared (figure 10). The proportion of firms reporting that labour is the main constraint on their production continues to ease.
- Firms are reporting much lower past and expected wage settlements (figure 11).

Figure 8. Job ads and applicants per job ad



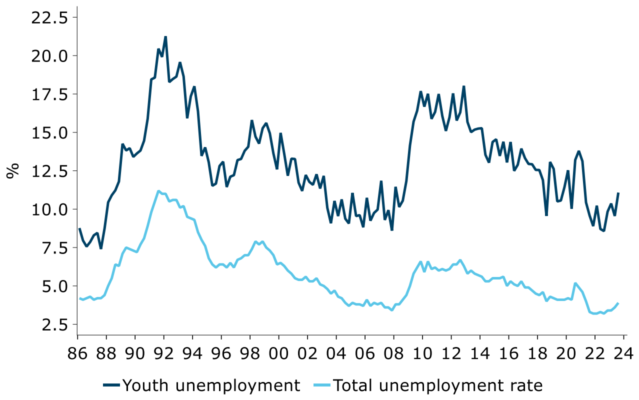
Source: SEEK, Macrobond, ANZ Research

Figure 10. Ease of finding skilled and unskilled labour



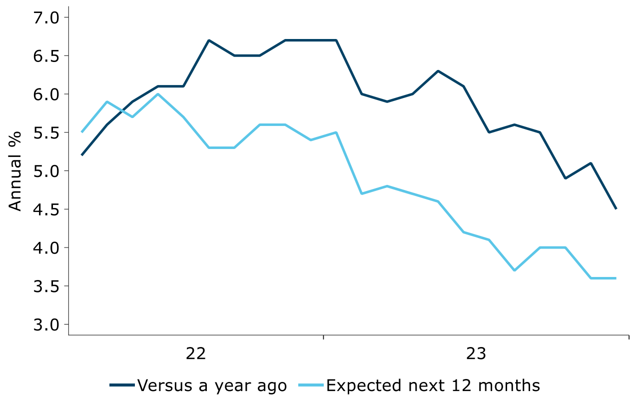
Source: NZIER, Macrobond, ANZ Research

Figure 9. Unemployment rate and youth unemployment rate



Source: Stats NZ, Macrobond, ANZ Research

Figure 11. ANZBO past and expected wage settlements



Source: Macrobond, ANZ Research

Looking at the range of labour market capacity indicators the RBNZ focuses on, we estimate that the labour market is already no longer inflationary.

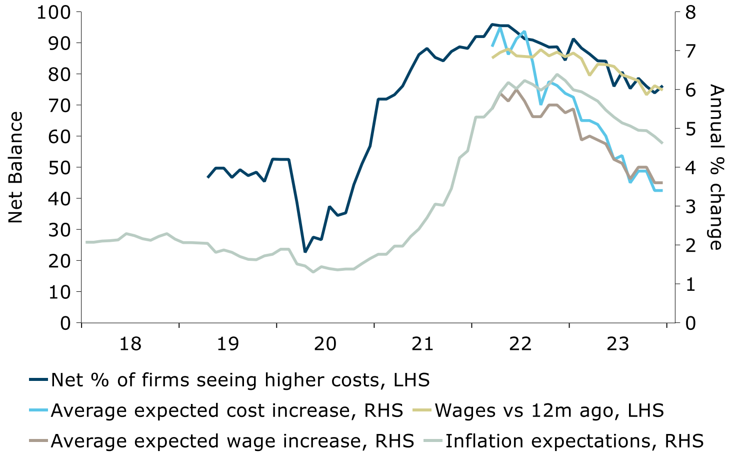
Complicating the picture somewhat is the fact that employment indicators outside of job ads have remained robust: employment intentions are rising and filled jobs continue to lift. What squares the circle is the ongoing catch-up from the massive pent-up demand for labour from the period when the border was closed. Estimating how much of this dynamic remains to play out is difficult, but intuition suggests that after 18 months and nearly quarter of a million arrivals, it must be close. Anecdote and media stories are starting to switch to new immigrants finding their jobs disappearing, particularly in construction, and local workers will also be displaced by migrants to some extent. Overall, the risks seem tilted towards unemployment rising faster than the RBNZ forecast back in November.

CPI inflation is falling

Our forecast for next week's Q4 CPI inflation is slightly lower than the RBNZ's (0.6% q/q versus 0.8% q/q), which would see headline annual inflation drop from 5.6% to 4.7% y/y. But the expected surprise is all on the tradable side, so has no implications for the OCR outlook. Our forecast for non-tradable inflation is the same as the RBNZ's (a fall from 6.3% to 5.7% y/y).

Most direct inflation indicators continue to track lower. Expected costs and wage expectations, past wages, inflation expectations: all are well off their peaks and dutifully trending lower, while still being too high in absolute terms (figure 12).

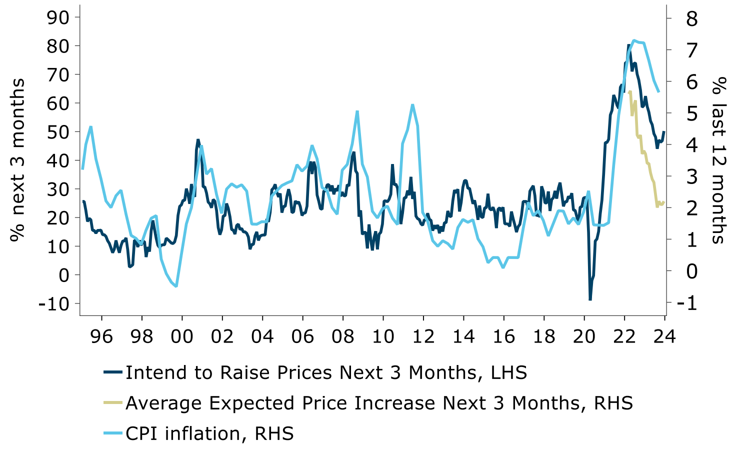
Figure 12. ANZBO cost & wage measures and inflation expectations



Source: Macrobond, ANZ Research

There is one fly in the ointment: the stubbornly high proportion of firms survey who intend to raise their prices. As figure 13 shows, that's risen from a trough of 44% in August to back over 50% in December. And the average expected price increase over that time has risen too. Since costs and inflation react to economic activity with a lag, it is entirely reasonable to expect that these measures will soon resume falling towards where they need to be. But as long as there is a chance that progress in bringing inflation down could stall, the RBNZ will remain cautious of declaring 'job done' prematurely.

Figure 13. ANZBO pricing intentions and CPI inflation



Source: Macrobond, Stats NZ, ANZ Research

Wild cards

It's worth recalling that there are plenty of things that could change the economic and inflation picture abruptly, but the RBNZ will take a "cross that bridge when we come to it" approach to these kinds of risks.

- **Oil prices.** Geopolitical risks abound, but oil prices have been remarkably chilled. A sharp increase in oil prices is certainly not our forecast but could put the RBNZ in a pickle, as we discussed in this note.
- **Shipping costs.** Due to drought and geopolitical issues, the world's major shipping canals are operating significantly under their usual capacity. The observed rise in shipping costs could add perhaps half a percent to NZ CPI inflation, if sustained. The RBNZ may or may not build any of this into their CPI forecast.
- **El Niño.** It's not playing out like a typical El Niño system, but there's plenty of summer to go, with potential disruptive effects on New Zealand's food production and export earnings. Meteorologists are warning of the risks of both drought and extreme rain events in the months ahead.
- **Fiscal policy.** The new Government is on a mission to cut spending, but also on a mission to deliver tax cuts. How those two things balance out in terms of fiscal stimulus remains to be seen, and won't be known with a great deal of certainty before the May Budget.
- **Global economic risks.** Debt has increased sharply in recent years, followed by a dramatic increase in interest rates, and one can't rule out that financial stresses could re-emerge in some of the more opaque parts of the global financial system even now that rates are off their highs.

Bottom line: our OCR call

Putting it all together, it's clear as mud, frankly. But the murkiness is around a less inflationary baseline than was evident in November – the RBNZ has more runs on the board than they knew, in terms of cooling activity.

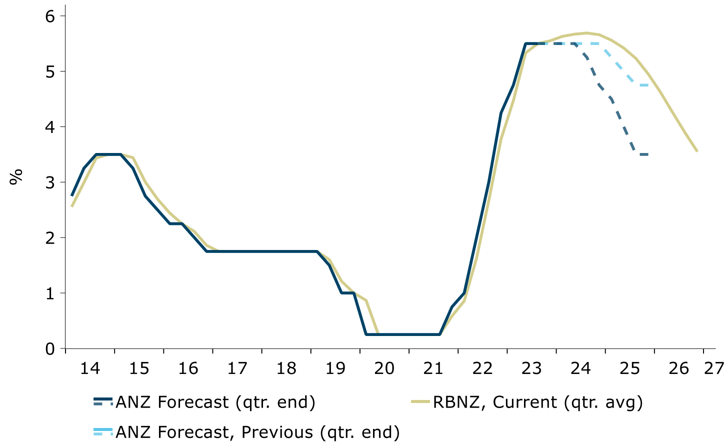
Our current best estimate is that the RBNZ will be ready to cut the OCR by the August MPS, assuming no wild-card developments. We expect inflation to be back in the band in that quarter (Q3); we are forecasting unemployment to have cracked the 5% mark (and to still be headed higher); and we estimate that the output gap will be deeply negative. With this economic data in the rear-view mirror, the risk of seeing inflation run away again would be much smaller than the risk of unnecessarily pushing the economy into a state that requires significant stimulus to revive it.

The risk of holding policy too tight for too long and the costs of potentially easing too soon are by nature asymmetric. If you cut a bit late, you just cut faster and hope it comes out in the wash with little harm done. If you realise you have cut too soon, you have to try to haul the market back for a second round of hikes with much bigger swings in rates and potentially damaged inflation-fighting credibility. And even just giving the market the green light to price cuts aggressively could see fixed mortgage rates fall meaningfully, easing monetary conditions and giving the housing market a second wind.

Upshot: don't expect a lot of advance warning of policy easing. The sensible strategy for the RBNZ is to deny-deny-deny-cut.

For the sake of argument, following the first cut we then have a steady string of cuts taking the OCR back to 3.5% a year later to the RBNZ's forecast horizon neutral OCR estimate (figure 14). In real life, the OCR tends to go up the stairs (admittedly more of a ladder this cycle!) and down the elevator, due to the asymmetric nature of positive and negative economic shocks, but we won't attempt to anticipate the unforecastable.

Figure 14. OCR forecast



Source: RBNZ, Macrobond, ANZ Research

What could make us change our view?

We’ve been pretty upfront about the uncertainty about how this year could pan out. So what could see the RBNZ cut earlier than August?

- A disinflationary shock, be that global or local (eg trading partner growth, energy costs, severe drought).
- Unemployment and other spare capacity indicators rise faster than the RBNZ expects. The risks appear tilted that way for unemployment, but the risks around other capacity indicators are more mixed.
- Pricing intentions gap lower, making up for lost time.
- Fiscal policy is meaningfully more contractionary than expected, eg cuts to spending are deep, and tax cuts are significantly reduced, deferred or cancelled.

What could delay a cut beyond August?

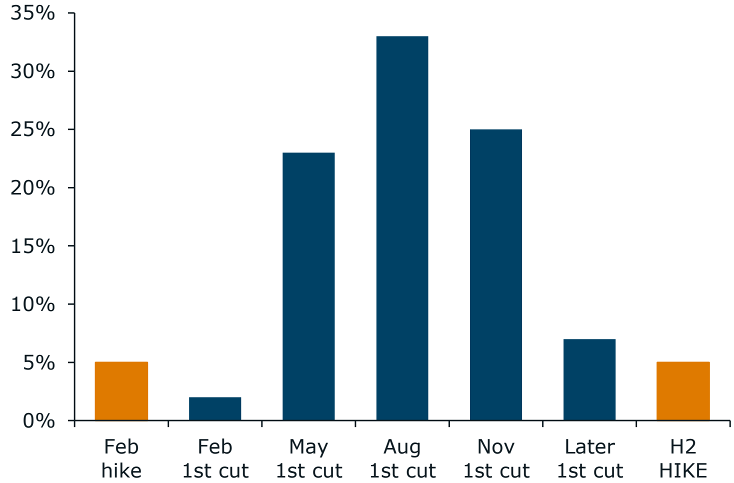
- The rebound out of recession is imminent and enthusiastic as the demand-side impacts of net migration kick in with gusto.
- Evidence of stickiness in non-tradable inflation emerges in both inflation indicators and CPI data itself.
- Sharp falls in fixed mortgage rates bring about a second wind in the housing market that leads to a rebound in consumption.
- Tax cuts outweigh spending cuts on the fiscal side.

What could bring about a hike?

- The RBNZ in November made its intolerance clear for any kind of upside surprise to inflation. CPI data is next week – as noted above, the only surprise for the RBNZ we’re anticipating is a small helpful one on the tradable side. But never say never! All else equal, the weaker starting point for the economy means the bar is higher for a non-tradables inflation surprise prompting a hike in February. But it’s not insurmountable. We and the RBNZ are forecasting a fall in non-tradable inflation from 6.3% to 5.7%. Anything with a 6-handle could spook the horses.
- The other scenario for another hike is that inflation levels out too high. But ongoing disinflation is pretty much baked in for the next six months due to previous economic weakness, so this is not likely a risk the market will need to think about imminently.

Forecasting anything beyond six months out is best thought of as an interesting thought experiment at the best of times, and as we’ve outlined, there are lots of moving parts on the supply side of the economy currently. So we’re happy to be upfront in saying that we don’t have strong conviction on August as the timing. Figure 15 below outlines how we currently see the odds. Fair to say everything is on the table. Indeed, the table needs a serious declutter, even abstracting from the possibility that the first cut is at a Review rather than a Monetary Policy Statement.

Figure 15. ANZ Research's odds of the next move in the OCR



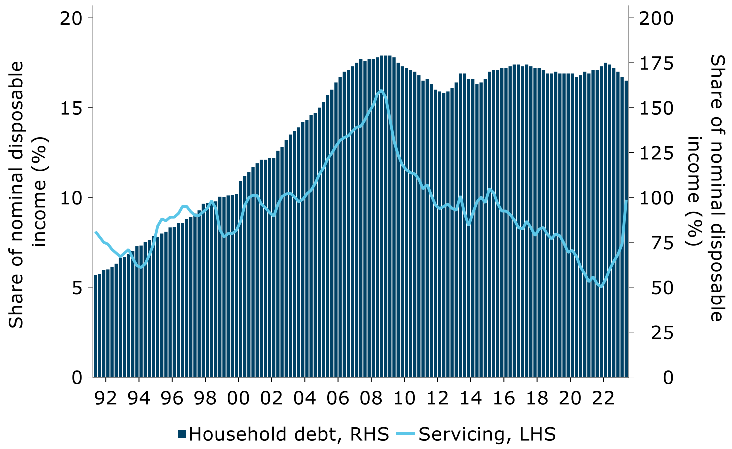
Source: RBNZ, ANZ Research

There are two arguments for cutting imminently that are unconvincing, in our view, yet which might seem intuitive to someone who doesn't have much time to devote to studying the NZ data.

a) Because we're in recession, cuts will come soon. As discussed in the strategy section above, a *prolonged* period of sub-par activity has been the plan pretty much from the get-go of this hiking cycle.

b) Because New Zealand hiked early, they'll cut early. The IMF estimates that New Zealand had the most overheated economy in the world in 2022, no doubt related to the fact that fiscal stimulus has been far greater and prolonged here than in most countries to which we typically compare ourselves. The RBNZ has faced a bigger job than most, and it's not done yet. It's also worth remembering that the RBNZ has not hiked the OCR to anywhere close to its 2008 peak (8.25%), unlike the Fed, the Bank of England, or the ECB. The shock value of the rapid increase in rates is absolutely real; the impact is clear. But rates aren't actually that high – we see the household debt servicing burden peaking at around 11%, compared to over 15% in 2008 (figure 16).

Figure 16. Household debt servicing



Source: Stats NZ, RBNZ, Macrobond, ANZ Research

Markets

Our new OCR forecasts suggest that New Zealand swap rates and bond yields will fall further over time, thanks mainly to our updated expectation that the RBNZ will be comfortable taking the OCR back to a more neutral level of 3.5%. However, it will be a patience game for markets, which are gunning for the first cut in May (with a full 25bp cut priced in by that date). While we acknowledge the tendency of markets to front-run the RBNZ, we do think markets have gotten ahead of themselves in the short term.

Conditions are thus ripe for the upward correction currently underway to extend a little further. We're not talking a big correction, and timing will be everything. All going to plan, OCR cuts are coming – and sooner than we envisaged late last year – but we don't see them coming as soon as markets expect, and the RBNZ is unlikely to endorse them until they are actually ready to cut. That doesn't just put markets in a tough spot; it's also suggestive of volatility, which we think will broadly take the form of rates backing up slightly near term before falling more aggressively from mid-year.

On the currency front, as we have seen this month, lower interest rates and expectations of earlier OCR cuts have been a headwind for the Kiwi, but if we do see rates markets correct higher, that has the potential to draw a line under NZD/USD, especially with the Fed on track to deliver deeper cuts this year, having made better progress in taming inflation.

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Last updated: 18 April 2023

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