WESTPAC ECONOMIC BULLETIN

Review of RBNZ May 2023 Monetary Policy Statement.

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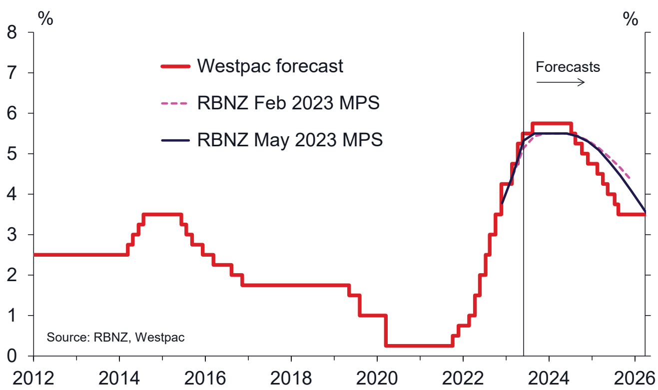
Mission accomplished? Yeah... nah.

- The Reserve Bank delivered the expected 25 basis point increase in the OCR, taking it up to 5.50%.
- The Reserve Bank strongly signalled that the peak in the OCR is in, but easing remains a long way off – towards the end of 2024.
- We continue to see significant upside risks to the Reserve Bank's growth and inflation outlook from the migration surge and government spending. We see the OCR rising 25 points at the August meeting as these risks become clearer to the Reserve Bank.
- After August, we see risks of a further increase in the OCR after the October election. And once the peak is reached, we have pushed out the time when we see the first cut in the OCR to occur to July 2024, to reflect the reduced OCR peak in the face of still significant inflation risks.

OCR forecasts



The RBNZ increased the OCR as expected to 5.5 percent.

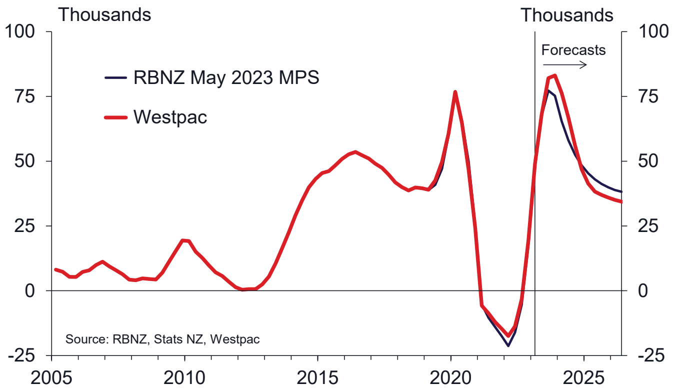
However, the big surprise was in the forward profile, in which the RBNZ strongly suggests that it is on hold from here until at least mid-2024. We see some upside risks to the RBNZ's view, but for now see the RBNZ on hold in July, a 25 point rise in the OCR in August and then an ongoing tightening bias from there.

People keep on moving.

It's clear that the resurgence in migration is occupying a lot of the Reserve Bank's thinking – the word appears 47 times in this *MPS*, compared to just four times in February. The effects of migration are somewhat mixed, but the RBNZ has traditionally regarded it as a source of net demand and of inflation pressures. For instance, the minutes of the April policy meeting, where the migration rebound was addressed for the first time, noted that "activity associated with rebuilding following recent extreme weather events will provide a boost to activity and inflation, as will rising long-term net migration."

But today's statement was much more equivocal about the issue. First, there was a concerted effort to play up the short-term nature of the surge. The minutes noted that "there were reasons to believe that current strength reflects pent up demand, and will prove temporary." The first part of that is not in dispute. The RBNZ's net migration forecast isn't actually far from our own – they expect a net inflow of 75,000 working-age migrants over this year, easing to around 40,000 people per year in the longer term. Our forecast of 100,000 net arrivals this year equates to around 83,000 in working-age terms (and our longer-term assumption is a bit lower than theirs).

Net migration (annual, working age)



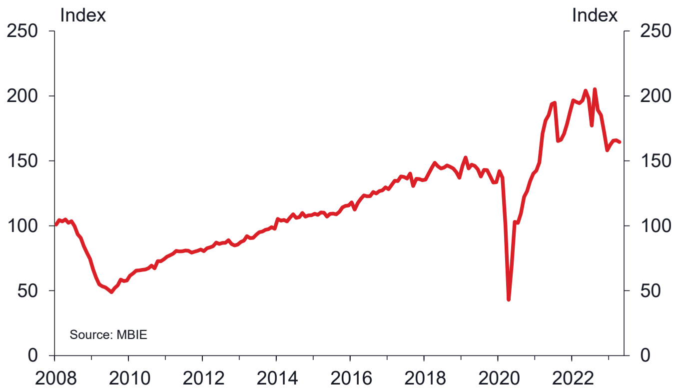
But we are much more cautious about the 'temporary' nature of this surge. The fact is that we have two years' worth of pent-up demand to live and work in New Zealand, during which time we continued to approve visas in large numbers. There's a high risk that these inflows could peak higher and last for longer than what we and the RBNZ have allowed for.

That said, an upside surprise on the migration figures wouldn't be enough on its own to shake the RBNZ from its view. They would also need to see it having a different impact on the real economy and on inflation than what they have assumed.

In particular, the RBNZ seems to be putting a lot of weight on the idea that migration will ease the labour shortages that have plagued the country for the last few years. They note that job advertisements have fallen substantially from their mid-2022 highs, as New Zealand's border was reopened and the surge in migrants began.

Job ads are not weak by any means – they've come down from very elevated readings to something that's still substantially above pre-Covid levels. And those previous elevated levels may have been because jobs that were previously filled by looking overseas instead had to be advertised locally during the border closure. With that restriction now lifted, local advertising has dropped back to normal levels. But that doesn't mean that there's been any easing in the demand for workers. And, as the March quarter labour force survey showed, employment is still outstripping population growth, and the participation rate has continued to reach new record highs. This still looks like a very tight labour market.

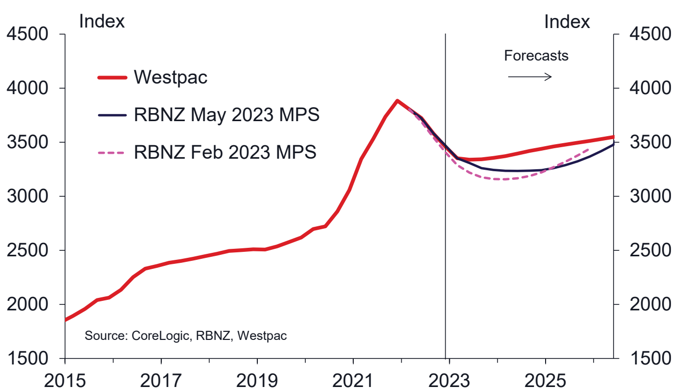
Online job ads, seasonally adjusted



The RBNZ has also tended to downplay the impact of migration on the housing market, although it has lifted its house price forecast to some degree. Housing is the part of the economy where migration is most obviously a net inflationary force, because the supply of new homes is relatively unresponsive. (This pressure on house prices occurs regardless of whether migrants are buying or renting, since somebody has to own the houses that they rent.)

The RBNZ is forecasting a further 3.5% fall in house prices over the next year before they bottom out. However, the most recent REINZ sales figures hint that the turn in the market may have already arrived. And the upturn in house prices in Australia – which has seen a similar resurgence in net migration – should serve as a warning for what might come next here.

House prices



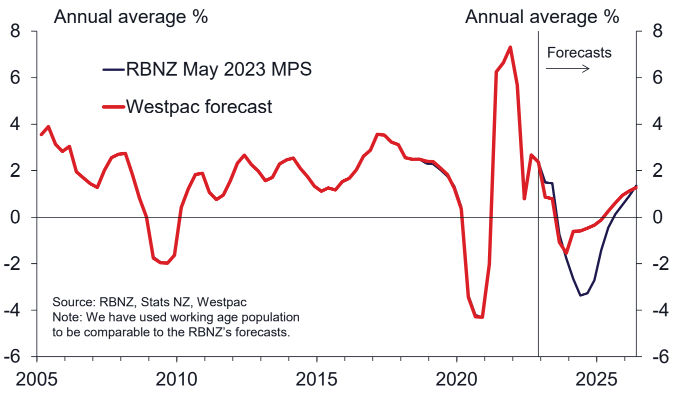
The shape of the economic cycle seems to overstate disinflationary pressures.

Digging into the details of the RBNZ's May policy statement, we think the forecasts underlying today's dovish policy decision are likely to understate the strength of demand pressures in the economy.

The commentary in the MPS noted softening demand in some interest rate sensitive areas, a point that we ourselves have previously highlighted. The RBNZ also highlighted the gradual pass through of OCR hikes to rates that borrowers are actually paying and that debt servicing costs will continue to rise over the months ahead – again, something we have frequently highlighted.

However, while we agree that tighter financial conditions will be a significant drag on demand, we think the RBNZ may be overestimating just how much demand will soften. In fact, if we look at the RBNZ's assumption for per-capita spending growth, the central bank expects that rate hikes to date will see spending dropping even more sharply it did during the 2008/09 Global Financial Crisis (Note: the RBNZ provides forecasts for the working age population, which we've used in lieu of total population).

Real per capita consumption growth



Even though there will be a good deal of belt tightening from households over the coming months, we're not as pessimistic as the RBNZ is on this front. A key reason for this is the state of the labour market – employment levels remain high, and rising wages are helping to support household spending. And although we do expect the labour market will cool over time, we expect that the downturn will be more modest than the RBNZ expects (especially if the RBNZ stays on hold, as their forecasts imply).

If we're right, it's likely that domestic demand and inflation pressures will exceed the RBNZ's forecasts. Some aspects – for example around the housing market could show up by August while others likely will look more obvious later this year.

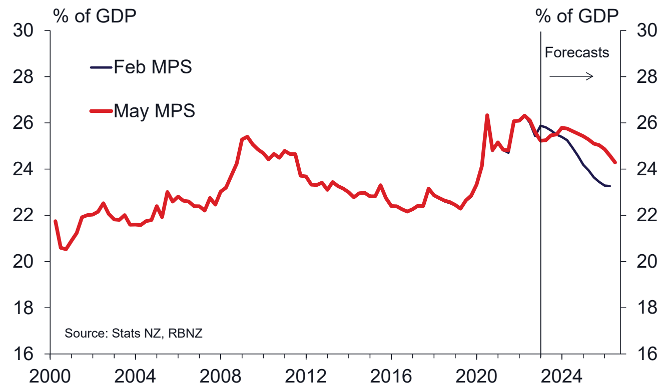
The profile for government spending seems implausibly low.

It's also notable that government spending is not seen as a significant driver of inflation pressures, despite the RBNZ having inserted the recent stronger Budget estimates into its projections.

We see more risk that government spending adds to inflation pressures than the RBNZ sees or acknowledges. In the *MPS*, the Committee noted that "broader government spending is anticipated to decline in inflation-adjusted terms and in proportion to GDP". For our part, we point out that while this proportion declines over the long term, fiscal policy is actually expected to be quite stimulatory in the year ahead, which is the more relevant horizon for monetary policy decisions today.

Secondly, we expect that the longer-term government spending projections will likely be revised higher over time relative to the Budget 2023 projections. Indeed, the Treasury has previously noted that its projections are "not automatically adjusted for expected changes in price or demand." Put differently, the falling government spending as % of GDP infers cuts to public services like health and education and, at this juncture, we'd suggest that such cuts are unlikely.

Real government spending (% of GDP)



The Reserve Bank's monetary policy strategy has some risks.

The Monetary Policy Committee has taken the strong, and potentially courageous, view that an Official Cash Rate of 5.5 percent, if held for long enough, will adequately constrain any upside risks to the growth outlook and exert considerable disinflationary pressure.

We noticed that, for the first time the Committee held a vote on the OCR decision, debating between no change and a 25 point hike. Two members voted for no change and the others for the 25 point increase. Such a range in views is normal when nearing the end of the cycle. Some members discussed potential upside risks to house prices and the economy from migration, but on balance the MPC felt sufficiently confident that a 5.5 percent OCR will be sufficient to balance those risks.

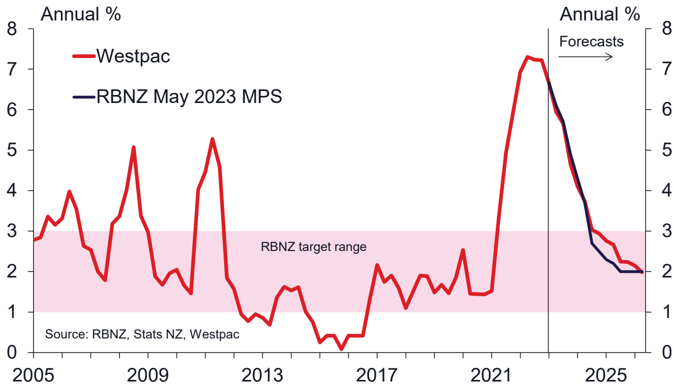
Non-tradables inflation is still peaking but is set to fall quite quickly from the current 6.8 percent annual rate to around 4-4.5 percent in the next year as past very high quarterly contributions from items such as construction costs fall out of the calculation. The real question though is what happens from there – and that's an issue facing all major economy central banks right now.

The work done now with interest rates, given the transmission lags, will deliver the benefits in terms of driving non-tradables inflation down to the target range (non-tradables typically sits around 3 percent when inflation is in the middle of the target range). Failing to put sufficient pressure on now means a higher chance that further disinflation doesn't occur from that 4-4.5 percent level reached in a year's time. This is where we see the Reserve Bank taking a few risks. Our view is that it would be better for the OCR to be lifted more now to head off the risks of non-tradeable inflation remaining persistently high (for example if the migration surge reignited the housing market, rentals, construction demand and costs etc) and an associated resumption of interest rate increases later this year and into next year.

The timing of the election in October is also unfortunate as there is the risk that valuable time might be lost in waiting for the election period to pass even as demand and inflation pressures build.

We think that the medium-term inflation risks would be better managed by the Reserve Bank doing a bit more soon to balance up the risks that some of the key judgements the RBNZ is making that population growth will quickly reverse and not add to housing market or inflation pressures or that government spending ends up being a lot higher than the government currently projects. More tightening up-front leaves room for an earlier return to lower interest rates and a more balanced set of risks around future inflation. We see the risks of undershooting the inflation target as remote, even if the Reserve Bank's judgements do prove well founded.

Consumer price inflation



Our view – watch for tightening in August.

August is pretty much the last stop on the line before the election period starts in earnest. By then, data on house prices and migration will be available that can either confirm or refute the Reserve Bank's current view. Similarly, the June quarter labour market report will be available.

Hence, we now see the RBNZ on hold in July, but anticipate an increase in the OCR of 25 points to 5.75 percent at the August Monetary Policy Statement.

The case for a further move in the OCR to 6 percent could become clearer to the RBNZ after the election in October. By then we expect that the housing market and migration pressures will be showing up strongly and non-tradables inflation will be looking quite sticky.

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