ECONOMIC BULLETIN

RBNZ policy considerations.

22 Nov 2023 | **Kelly Eckhold**, Chief Economist | +64 21 786 758 | kelly.eckhold@westpac.co.nz | X: @kellyenz

When's the pivot?

In this note we discuss what the RBNZ would likely need to see to deliver a policy easing in 2024.

- **We currently forecast the OCR to remain at or above its current level over 2024 but markets now see multiple OCR cuts beginning as early as May 2024.**
- **The RBNZ will need evidence that inflation will move inside the 1-3% target range within six months or so after beginning to ease, and stay there through 2025.**
- **It will take tangible signs that non-tradables inflation is trending down along with significantly weaker quarterly core inflation outcomes to prompt the pivot to interest rate cuts.**
- **The RBNZ will need to be confident that excess capacity will grow and persist, which will require significant labour market easing and a restrained housing market.**
- **We don't expect these conditions can be met before the August MPS meeting. The subsequent easing cycle could be cautious and shallow.**

Our baseline forecast is that strong domestic inflation pressures will take some time to dissipate so that annual CPI inflation will likely remain outside of the RBNZ's target range until early 2025. We forecast the RBNZ will keep the OCR at least at current levels until early 2025, before beginning a measured easing cycle - broadly in line with the RBNZ's August projections.

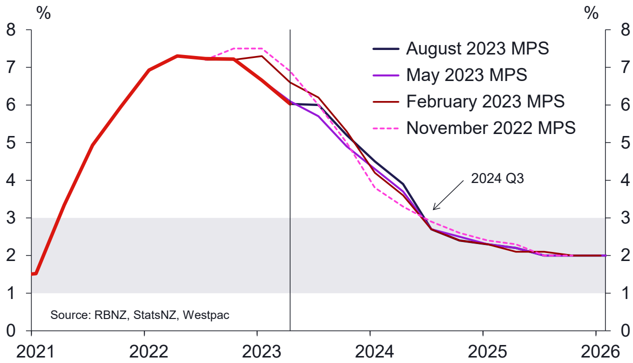
Recently markets have priced in easings beginning as soon as May 2024, reflecting both offshore and domestic factors. Markets now see the Federal Reserve cutting rates next year and local data have shown faster than expected disinflation in headline inflation as well as a raft of weak cyclical indicators that suggest growth is running below trend. We will reassess our forecasts after considering the RBNZ's November *Monetary Policy Statement*. Here we discuss the factors the RBNZ might put most weight if deciding to shift to an easing cycle at some further stage.

What would the RBNZ need to see to cause it to ease policy?

The RBNZ will need to be confident that inflation will be inside the target range in 2024 and stay there subsequently.

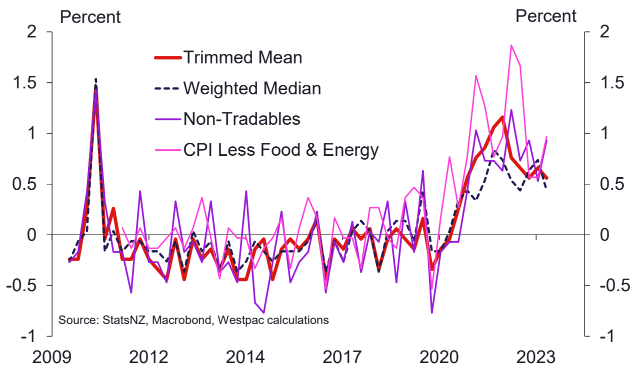
Since late 2022, the RBNZ has held the view that headline CPI inflation will reach the top of the target range by September 2024. We think this will continue to define the edge of their comfort zone for near term inflation. Recent weaker headline inflation data suggests the RBNZ will likely assess this criterion will be met. But the December 2023 and March and June 2024 quarter CPI outcomes will be critical in assessing progress, and those data are not available until April 2024.

RBNZ forecasts for consumer price inflation



The composition of inflation in the next couple of quarters is likely to be key in giving the RBNZ confidence that a durable disinflation trend is in place. The key relevant indicator would be a quicker than anticipated decline in usually more persistent non-tradables inflation. Core inflation measures such as non-tradables inflation currently are running at too strong levels (non-tradables inflation typically runs around 3-3.5% when inflation is inside the target range whereas now it's around 5-5.5%). We think the RBNZ would want to be confident that measures of quarterly core inflation such as the trimmed mean and median will decline to 0.5% on average and for non-tradeables inflation to around 0.75% a quarter.

Quarterly core inflation indicators relative to 1995-2019 average



The recent quicker than anticipated decline in tradables prices, while helpful, will likely be of secondary importance given their weaker persistence and greater volatility. Any evidence that weakening demand is impacting on margins in the tradables goods sector will be more relevant.

The RBNZ will want to be sure that a lower OCR will still see inflation return to the middle of the target range in time.

The RBNZ would also need to be confident that, after a reduction in the OCR, sufficient restraint remains to maintain inflation below 3%. The RBNZ won't need to see forecast inflation return to the 2% midpoint particularly quickly, but they will need to be confident that the initial easing (and those subsequently expected) would not leave risks of inflation moving higher again. We think they would also want to show inflation moving to the midpoint of the target range within a reasonable timeframe thereafter – even if that was sometime in 2026.

Labour market developments will be important.

Increased slack in the labour market will be key to providing confidence that excess capacity will be maintained for some kind of easing cycle to be appropriate. The RBNZ expects the unemployment rate to rise to 4.8% by the March quarter of 2024 (above the "NAIRU" estimated in the 4.0-4.5% range). Evidence that the unemployment rate is rising in line with the RBNZ's view, and signs that wage inflation is moderating more quickly will be important indicators to watch – although these indicators will come with a lag so it could be mid-2024 before sufficient evidence accumulates.

Housing market trends will be key.

Both the RBNZ and Westpac expect a further rise in house prices next year although our forecasts are materially more positive. Critical here is the assessment of the impact of population growth on housing and rental markets and the impact of any future government policy changes that might improve after tax returns for housing market investors. The RBNZ has reserved judgement on the impact of migration on the housing market and broader economy until it observes developments during the peak summer trading period. We think it will be hard for the RBNZ to confidently ease should our forecast of 8% house price growth next year be realised and if rents growth (a key element of core inflation) does not moderate.

The path for domestic spending.

The assessment of the feed-through from past policy tightening to consumer spending will be important. Critical here is the assessment of whether the increasing level of the effective mortgage rates will be sufficient to durably restrain spending.

Other factors of relevance but at a second tier of importance.

Inflation expectations: Inflation expectations have declined recently but remain at high levels. These indicators will need to fall closer to historical norms (for example, the RBNZ's surveys of 2-year ahead business sector expectations are at 2.76% compared the average 1.9% seen in 2019 and the RBNZ's household survey shows 1-year ahead expectations at 5.5% versus 2.8% in 2019).

Government spending: If the new centre-right government pursues a much more rapid fiscal consolidation than currently assumed there could be scope for an earlier easing of monetary policy. It may be hard to assess this ahead of the 2024/25 Budget.

The global backdrop: Policy easing in other countries, won't directly lead the RBNZ to ease policy. But the RBNZ will have regard to policy actions taken offshore if they convey information about a weaker global economic outlook or if financial conditions are impacted (for example through a higher exchange rate). The RBNZ will likely be monitoring inflation persistence in other countries as an indicator of what to expect here.

How soon could the pivot occur?

Absent an extreme shock, such as a significant synchronised deterioration in the global and local economic outlook, the earliest we can foresee the beginning of an easing cycle is the September quarter. The plausible path to such a scenario would probably require the following:

- The June quarter CPI (released mid-July) pointing to inflation being on track to move back inside the target range by end 2024 and core inflation measures moderating such that inflation can be expected to remain within the target range;
- The June quarter labour market surveys (released early August) showing a significant move higher in the unemployment rate consistent with the RBNZ's forecasts;
- Continued subdued domestic demand (relative to potential growth) and the housing market not rising strongly and derailing the disinflation process;
- Further falls in inflation expectations and pricing intentions indicators;
- Some reassurance that disinflationary trends in New Zealand might be reinforced by similar trends elsewhere.

CONTACT

Westpac Economics Team | **westpac.co.nz/economics** | nzeconomics@westpac.co.nz

Kelly Eckhold, Chief Economist | +64 9 348 9382 | +64 21 786 758 | kelly.eckhold@westpac.co.nz

Satish Ranchhod, Senior Economist | +64 9 336 5668 | +64 21 710 852 | satish.ranchhod@westpac.co.nz

Darren Gibbs, Senior Economist | +64 9 367 3368 | +64 21 794 292 | darren.gibbs@westpac.co.nz

Nathan Penny, Senior Agri Economist | +64 9 348 9114 | +64 21 743 579 | nathan.penny@westpac.co.nz

Paul Clark, Industry Economist | +64 9 336 5656 | +64 21 713 704 | paul.clark@westpac.co.nz

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