WESTPAC ECONOMIC BULLETIN

Preview of RBNZ October 2023 Monetary Policy Review.

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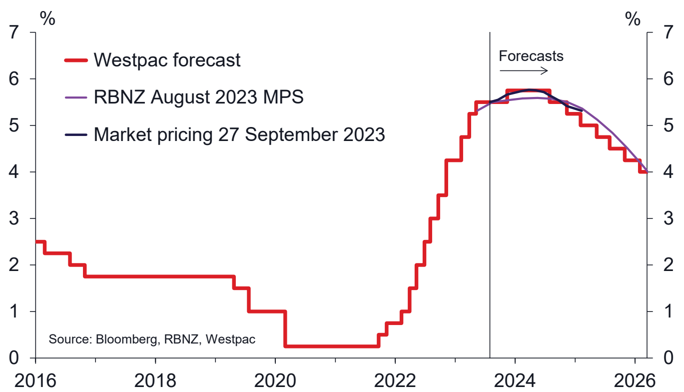
Searching for direction.

- We think the RBNZ will keep the OCR at 5.5% at next week's meeting.
- A surprise tightening to 5.75% is a risk, but we think no more than a 10-20% chance.
- We expect the RBNZ to retain the tightening bias expressed in the August *Statement* and will aim to retain maximum flexibility to tighten (or not) in November should data warrant.
- We expect guidance on how the RBNZ has interpreted recent economic developments – especially the interplay between stronger GDP growth earlier in the year, as well as the recent upswing in net migration and the housing market, but weak cyclical demand indicators and a challenging external outlook.
- We hope for guidance on the factors the RBNZ will focus on to determine if a November tightening is warranted. If provided, the CPI and labour market indicators should be prominent in that guidance.

The view in August.

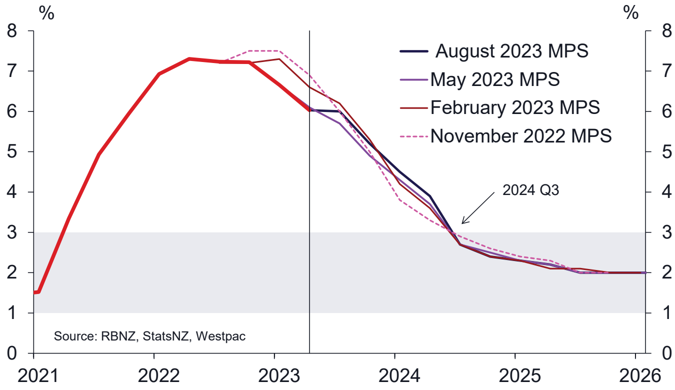
The August *Monetary Policy Statement* represented a significant shift in tack for the RBNZ relative to the previous two OCR reviews, with a much more equivocal outlook for interest rates. The August projection for the OCR signalled a 36% chance of a further 25bp hike in the first half of 2024. It also showed a delayed and more gradual easing profile starting in the September quarter of 2024.

Official Cash Rate forecasts



The RBNZ saw two-way risks to the OCR: on the upside the Bank noted still strong and persistent inflation, a strengthening housing market and still resilient labour market; and on the other was significantly weaker external demand and weak cyclical growth indicators. The net of these risks was clearly to the side of increased concern that growth might not be weak enough and/or easing fast enough to bring inflation back to the target range by the end of 2024. The objective of seeing inflation back inside the 1-3% target range has been a consistent feature of the RBNZ's forecasts since late 2022 when it began in earnest to push the OCR to 5.5%.

Consumer price inflation forecasts



The action since then.

Since August, the data have pointed in the direction of increased concern in terms of the potential persistence of inflation pressures. Key factors have been:

- **Resurgent house prices:** the REINZ house price index continued its recovery in August rising 0.8% (seasonally adjusted) building on a 0.7% rise the previous month and confirming the housing market has found a firmer base.
- **Ongoing strong inward migration and population growth:** Migration data in recent months has not slowed and look set to continue breaking records in the coming months. Arrivals remain strong even as departures have picked up (especially among New Zealanders). Net migration now looks set to peak in the 105-110,000 range before the end of the year.
- **A stronger starting point for GDP growth:** Growth in the first half of 2023 was significantly stronger than market and RBNZ expectations. After taking account of revisions, the economy was 0.5% larger in aggregate through Q2 2023 compared to the RBNZ's expectations in August.
- **Strengthening rents** reflecting housing pressures due to strong population growth. The monthly flow measure for rents grew 6.1% in the year to August, while the stock measure increased 4.1% and is steadily rising. The latter is already higher than usually seen when inflation is inside the 1-3% target range.
- **Strengthening business confidence** perhaps related to reduced cost pressures and prospects of a change in government (based on recent opinion polls).
- **Very strong oil and petrol prices:** Oil prices are around 9.5% higher than assumed in the RBNZ's August MPS forecasts. Combined with the 1% lower exchange rate, that implies significant additional tradables inflation pressures in the CPI and throughout the production chain. That said, higher oil prices also imply a further squeeze on household incomes.
- **Continued employment growth:** The monthly employment indicators suggest a still growing jobs market although indicators of labour market shortages have continued to ease, suggesting that job growth is insufficient to soak up growth in the labour force.

On the other side of ledger, the number of factors pointing to softer inflation pressures is sparser. Key factors have been:

- **Falling food prices** which may have deducted 0.1ppts from CPI inflation in the September quarter (based on our forecasts).
- **Commodity prices** are slightly lower than assumed by the RBNZ in August as large falls in dairy prices have only been partially offset by better outcomes in the dairy auctions in September. That said, the recent rebound in dairy prices may partially reflect growing concerns that El Nino could generate a summer drought in the east of the country, which could have large negative implications for agricultural output next year.
- **Consumer confidence remains weak** and retail trade/card spending volumes correspondingly weak consistent with weak discretionary consumption demand as households grapple with the twin challenges of rising debt servicing costs and cost of living pressures.
- **Business PMIs are consistent with low or negative growth.** Both services and goods sector PMIs remain weak and suggest that we are set for a markedly weaker growth performance in the second half of 2023.
- **A substantial lift in global long-term interest rates over recent months.** This has acted to significantly tighten monetary conditions in New Zealand despite no change in the OCR. Indeed, since the RBNZ last raised the OCR in May, the standard 2-year mortgage rate for new borrowing has increased by around 40bps.

What they might say about what it means.

We think the net of these forces will imply upward revisions to the RBNZ's internal projections for inflation and interest rates. Hence, we anticipate an acknowledgment of this in the MPR press release and discussion on the factors the RBNZ see as most critical for their projections. Of particular interest will be:

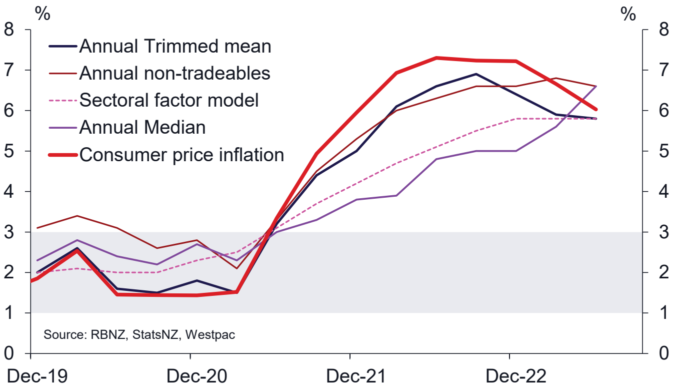
- Their assessment of the extent to which the upside surprise to GDP reflects supply as opposed to demand factors.
- Their view on the extent to which they can "look through" higher oil and petrol prices and focus more on the negative medium term growth implications compared to the short term tradables inflation and expectations impacts.
- The impact of strong housing and migration related drivers for medium term inflation pressures.

The RBNZ's communications objective.

We think the RBNZ should be comfortable with current market pricing for the OCR in November and beyond and would not want to significantly disturb pricing. Ideally the RBNZ would want to leave the market in a position to price (or not) the November rate hike depending on how key data to come in October and November evolve, together with any other material developments in New Zealand or abroad.

To achieve this, we think it would be useful for the RBNZ to provide markers to guide markets on the key areas of focus. We expect that the RBNZ would want to highlight the importance of pricing related indicators in guiding their November view. The core inflation measures in the September quarter CPI are likely to be especially significant as these need to show tangible evidence of slowing.

Core inflation measures

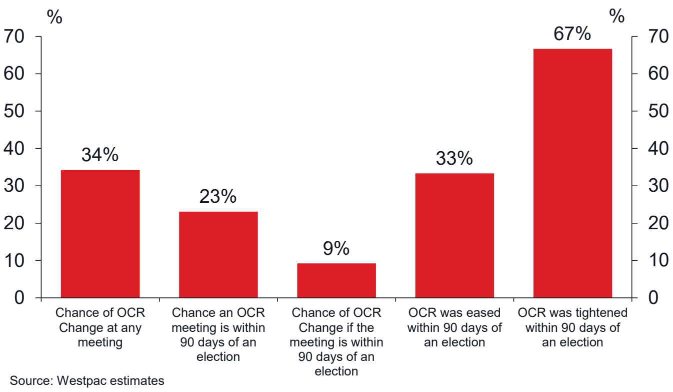


The risk scenarios.

On the hawkish side (perhaps a 20-30% chance), the RBNZ could leave the OCR unchanged but go as far as saying that in the absence of evidence of a significant easing of actual core inflation pressures, a tightening is probable in November. This would likely see the market move to almost fully price a November tightening now, with pricing likely only unwound should the CPI provide a material downside surprise.

A further less likely possibility is an actual tightening in October – which we rate as a 10-20 % chance. We note that in the period since the OCR regime began, movements in the OCR in the 90 days before an election are a lower than usual probability (about a third less likely than average). However, when these have occurred, they have usually been tightenings.

RBNZ Policy Rate Changes within 90 days of an election



A more dovish scenario (perhaps a 15%) would be the RBNZ indicating comfort with the current level of the OCR while maintaining the bias to tighten should inflation pressures not recede. This might be motivated by a desire to “look through” recent increases in oil and petrol prices and look forward to a significant weakening in domestic demand in the second half of 2023 and into 2024. The work being done by higher long term interest rates and thus fixed mortgage rates could also lead the Bank to that view.

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