ECONOMIC BULLETIN

Preview of RBNZ November 2023 Monetary Policy Statement.

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

Talking tough about doing little

- **We expect the RBNZ will leave the OCR unchanged at 5.5% at its November policy meeting.**
- **The RBNZ's forward profile for the OCR is likely to be little changed and suggest no change in the OCR in 2024.**
- **Short term inflation forecasts will be reduced, but the longer-term profile will likely be little changed.**
- **The RBNZ will be keen to ensure as much of the recent increase in mortgage rates remains in place for a while.**

The RBNZ's decision and forward track.

We expect the RBNZ will leave the OCR unchanged at 5.5% at its November policy meeting. There will be more interest in the profile for interest rates in 2024 given recent market speculation of a pivot towards OCR cuts in 2024. We think the RBNZ will show a slightly flatter OCR profile that will still convey an on-hold stance through 2024.

We anticipate that recent progress on tradables inflation will be acknowledged and incorporated into the RBNZ's short term inflation forecasts. But we also see the RBNZ continuing to emphasise the medium-term risks to inflation given that the level of inflation remains high and core inflation pressures (including non-tradables inflation) are yet to significantly moderate.

We think the RBNZ's objective will be to try to maintain recent tighter financial conditions by talking tough but doing little in 2024.

Key developments.

Prior to the October *Monetary Policy Review* we think the RBNZ likely interpreted the data flow as indicating slightly increased medium-term inflation risks. Key relevant factors that would have contributed to these concerns included: stronger GDP in the June quarter and hence less progress in reducing excess demand; ongoing jobs and employment growth (compared to expectations of a weakening trend); higher energy and fuel prices, and improved commodity prices compared to the downside risks apparent in August. Offsetting factors will have been further evidence of weak discretionary spending, investment, and some reductions of firm costs and business and household inflation expectations. Crucially, the significant rise in mortgage rates and longer-term interest rate expectations that occurred over the August-October period were a significant offset and could be the equivalent of another rate hike if sustained. Our assessment is that the net of these factors probably would have led to a slightly higher peak OCR but mainly an extension of the period over which the RBNZ expected the OCR to remain at 5.5% (and into 2025).

Since then, the data flow has been supportive of RBNZ's view that a 5.5% OCR will prove sufficient. Tradables inflation has fallen more quickly than anticipated. Labour market indicators showed signs of the required move higher in unemployment and softening wage growth (at least in the private sector). The price of oil receded from its October highs, reducing headline inflation and expectations concerns the RBNZ may have had. Also, we have continued to see weakness in cyclical demand indicators (retail spending, PMIs, credit growth, imports) which the RBNZ will see as removing any pressure it was feeling to lift the OCR. On balance there's likely little net change in the OCR profile required for the totality of the data seen since August.

Some key medium term inflation risks remain which we think will make the Bank reticent to validate the market's pricing of rate cuts next year. A key issue is ongoing strength in population growth and migration with associated pressures on housing and rental markets. The RBNZ recognises the risks here but is reserving judgement until next year to see if the composition of migration or the level of interest rates proves sufficient to balance the risks. We don't see them making substantial judgements aside from perhaps some further upward adjustment to the forecast of near-term potential growth and a further modest upward adjustment to house price expectations - enough to acknowledge that the risks but not enough to warrant action.

The RBNZ may have some discussion on its initial take on the implications of the new government for the macroeconomic outlook. As of writing no coalition agreement has been signed and hence, we don't have a fully articulated set of policies to go on. The RBNZ probably also won't have much detail but will have an idea of the broad parameters of what the next government will do and could have a box discussing the potential implications (it did so in 2017, following the election of the new Labour-led government). The most prominent policies likely would relate to the housing market (which would likely increase inflation concerns at the margin) and the general fiscal stance (which will likely be supportive of disinflation, again at the margin). We don't think the new government's policies will significantly shift the OCR stance now. Certainly, the PREFU fiscal assumptions, with their slightly more restrictive stance, will be incorporated into the RBNZ's updated forecasts.

The communications objective.

We think the RBNZ will want to discourage markets from pricing an early reduction in the OCR. Mainly, this is because the RBNZ will not want to encourage any more easing in financial conditions than appropriate given the still present medium-term inflation risks.

The RBNZ will be aware of the current tendency for markets to run with dovish expectations and we think it will tailor communications to offset that tendency. Hence, they will talk tough about doing nothing for the foreseeable future. This likely means the RBNZ won't move their OCR forecast profile much. We expect they will emphasise a determination to get inflation sustainably inside the target range in 2024 and keep it in there in 2025. Those medium-term risks will be enough to keep them talking tough and pushing aside market views of 50-100bps of easing in 2024.

We see three main scenarios:

- Baseline case (70% probability) the OCR remains at 5.5% and the forecast track still shows the small chance of a rate hike in H1 2024, but the OCR remains at 5.5% until early 2025.
- Hawkish case (10%) the OCR remains at 5.5% but the forecast track is revised up in H2 2024 to convey an increased risk of higher rates through 2024. This would be linked to risks of housing strength, a slower rise in the unemployment rate and an ongoing sluggish response of core inflation to tight monetary policy (even though tradables inflation will be revised lower).
- Dovish case (20%) the OCR remains at 5.5% and the OCR track is revised down to a flat profile at 5.5% until Q4 2024 with a full cut indicated by the February 2025 MPS. There may be some chance of a cut at the Nov 2024 *MPS* on the assumption the Q3 CPI shows inflation inside the target range or provides sufficient confidence that it will be by end of 2024.

We don't think the dovish scenario will achieve the RBNZ's communications objectives, but it may attempt to discourage the pricing of earlier easings by stridently emphasising the near-term on-hold message. **As we discussed in our note "When's the pivot?"** we don't see many plausible scenarios for an OCR cut before the September quarter of 2024. There's still plenty of potential for upside risks given we haven't seen much evidence of non-tradables inflation pressures declining and the jury is still well and truly out on the impact population growth is going to have on demand and medium-term inflation pressures.

Our OCR view for 2024.

We still project a 25bp hike in the OCR in February 2024, with policy settings then on hold from there to February 2025. However, that call for higher rates teeters on a knife edge as the RBNZ has plenty of reasons for standing pat. We will review our forecast based on what the RBNZ tells us about its reaction function next week.

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