ECONOMIC BULLETIN

What we are looking for in the Monetary Policy Statement this week.

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What to look for from the RBNZ this week

- **This week's Monetary Policy Statement could be the most contentious in a while.**
- **We think the OCR will remain unchanged and stay unchanged for 2024.**
- **The key issue is whether the RBNZ is considering a change in monetary policy strategy – is it still a 5.5% OCR for longer approach or do rates need to go higher?**
- **The key will be what level of inflation the RBNZ is comfortable with in H2 2025?**
- **As will judgements on the persistence of non-tradables inflation and the importance of current weak economic momentum.**

Does the RBNZ want to change horse?

This week's February *Monetary Policy Statement* is one of the most anticipated OCR reviews since late 2022, when the RBNZ kicked off a further boost in the OCR from the then 3.5% towards the current 5.5% level. Right now, there is considerable divergence in views about the economic outlook and future path of interest rates. Our report last week canvassed the **arguments supporting both hawkish and dovish perspectives**.

Our preview discussed **our view on what we expect at the Statement**. Given our assessment of the recent data flow and the implications for the medium-term inflation outlook, we think the OCR will remain unchanged. And if the economy remains on its current trajectory, we expect the RBNZ to leave the OCR unchanged throughout 2024. But it is possible that the RBNZ might view the data differently to us or that it may change its approach even if they view the data the same as we do.

The key issue is whether the RBNZ will adjust it's strategy for the OCR for the year ahead. Since May 2023, the RBNZ has signalled an OCR at 5.5% for longer strategy when confronted with information suggesting sticky core inflation pressures and labour market resilience. Rate increases have not been ruled out in recent meetings, but there has been a preference from the RBNZ to extend the period where the OCR is held as opposed to tightening further. Some commentators have suggested this strategy will now change and market pricing reflects this to some extent. So, what should we be looking for in determining whether those commentators are merely jumping at shadows or whether there really is a change in RBNZ strategy coming sooner or later? This note discusses the main things we will be looking for in the RBNZ's commentary this week as we assess what the RBNZ's strategy will be going forward.

Obviously, the OCR change itself is a key metric!

In terms of outcomes of this meeting, it seems likely that the options open to the RBNZ are either no change or a 25bp increase – a surprise easing doesn't seem on the cards right now. But the key questions to ask are:

- If it's no change, does that signal comfort with the medium-term outlook or are there signs that either (a) a tightening is coming soon or (b) the RBNZ is prepared to further push out the period over which the OCR stays at 5.5%?
- If it's a 25bp increase to 5.75% then how much more tightening should we expect and when?

Where's the neutral OCR?

The level of the neutral rate could be a key driver of their strategy and their forward OCR profile. The RBNZ has made 25bp adjustments up at the last two *Statements*, but the neutral rate still sits at a relatively low 2.5%. They could be in the process of moving this up towards 3-3.5% (our own terminal level is 3.5%).

This judgement is not a technical modelling issue independent of how the MPC sees the stance of policy. It might make sense for them to further adjust the neutral rate higher if they judge that inflation is remaining stickier than expected at the current OCR (although the weak economy might give them pause on coming to that view).

But this assumption is a key driver of where the MPC sees the OCR ultimately going over time which will drive the medium to longer term OCR profile they publish. While we have little confidence anyone really knows where the neutral OCR is this judgement will give us a read on how large an eventual easing cycle to expect – all else equal. It matters less for what policy does in the next six months.

What is the desired level of CPI inflation in late 2025?

We think this is the critical judgement as views on this divide the hawks and doves. Can the MPC wait for the 5.5% OCR to do the job (the RBA approach)? In November, the RBNZ indicated the objective is to achieve 2% CPI inflation in H2 2025. Can the RBNZ go down the route of the RBA and allow more time for inflation pressures to subside? We are doubtful on this given the recent changes to the RBNZ's mandate that focus it on inflation more squarely. But if the MPC sees room to wait and push out the time when the mid-point can be achieved, then this would be significant and allow for sooner cuts (and kill off tightening expectations).

The shape of the OCR forecast profile.

Even if the OCR doesn't change, the MPC might still signal a change of strategy through the forward OCR profile. We can see a case for the RBNZ rattling the sabre but is it ready to strike on any provocation? If the RBNZ brought forward or increased the OCR peak in Q2 2024 then this tells us future tightening risk is real. Pushing the OCR profile down or back tells us the MPC still sees the OCR at 5.5% for longer as the preferred strategy. Similarly, pushing the peak OCR out and pushing the cuts out is also consistent with an unchanged strategy.

But what about if the RBNZ increases the OCR? The issue here is how quickly will we see any follow up hikes? We don't think that one tightening requires a firm view that another tightening will be forthcoming. This really depends on how sure the MPC is on the outlook. Their confidence on that score will be signalled in the near-term OCR profile. If it's steep, then a further increase in April will look likely. But if the MPC is not so sure then the forward profile will be flatter, indicating a preference to give the data more time to justify further movement (and on that score there is a lot more inflation available for the May Statement than in the April review).

An OCR profile showing more than one 25bp hike could be associated with a flat track after the last hike indicating a "higher sooner" strategy. In this case, the MPC could even consider bringing forward when the first cut could come.

The degree of concern on labour market adjustment.

As we noted last week, the labour market hasn't yet adjusted as quickly as the RBNZ expected. This has implications for the medium-term inflation profile. We will be looking for how much adjustment to the RBNZ's unemployment rate forecasts occur. Will the RBNZ keep the same peak unemployment rate (5.3%) or revise it down? Judgements here could tell us much about how much (if any) extra monetary policy work is required to get core inflation sustainably down.

The non-tradables inflation profile.

Does the RBNZ see as much near-term risk as Westpac (Q1 non-tradables 1.4% vs RBNZ November MPS 0.9%) and critically how persistent are these risks? We suspect OCR increases will be justified by increases in these forecasts if they occur.

Fiscal policy assessment.

What did the RBNZ take from the HYEFU and what is the bar required for *Budget 2024* to forestall rate rises? The RBNZ wasn't relaxed about this issue in November. The HYEFU was worse than PREFU although it didn't include most of the new Government's policies. Since HYEFU perhaps the most significant policy change was the small minimum wage increase. Will fiscal policy help enough?

The housing market and migration assessment.

This was a key theme last time and came out of the blue. We tend to think we will see less focus this time – the data still shows plenty of newcomers, rents exploding, but the housing market looks quiet. This suggests there is enough uncertainty there to not focus on too much. But the MPC's take on the issue could drive things either way. A comforting observation is the RBNZ's scenario in the November MPS:

"The first scenario was one of persistent domestic demand strength supported by strong population growth, with increases in rents and aggregate consumption feeding into greater inflationary pressure and higher house prices."

But this scenario isn't really playing out. Population growth and rents pressures are persisting, but stronger demand and house prices do not seem evident in recent data. Instead, we've seen weak retail sales, flat house prices, and weak (possibly recessionary) GDP growth.

Commodity price improvements and implications.

In August 2023, the RBNZ saw significant downside risks to the domestic economy from weak global demand that was a factor supporting their view that a 5.5% OCR would prove sufficient. This risk has significantly receded – although remains to some extent. If we assume improving export sector incomes and global growth (supported by easier policy offshore) then how much does that matter for policy here?

Economic momentum and the output gap.

The RBNZ Chief Economist suggested the big downward revisions to past GDP reflected might reflect potential supply constraints (due to weak trend productivity) as well as weaker than expected demand. What was less clear was the RBNZ's judgement on the very weak Q3 2023 outcome and indications that Q4 was also weak. We think the RBNZ will take that onboard and could be a big reason they hold fire for now, or even take a slightly more sanguine view about the medium-term inflation outlook if they conclude that there is indeed more spare capacity in the economy than estimated previously.

Was there a vote at the MPC?

The MPC has once formally held a vote (in May 2023) as there was no consensus on the appropriate policy setting. A key indicator of uncertainty will be if we see this again. A decision not to change the OCR by unanimous vote would clearly be less hawkish than one in which there is dissent.

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