Economic Note

Preview of RBNZ October Monetary Policy Review

2 October 2024

Mind the gap – and go 50

- We expect the RBNZ to cut the OCR by 50bp at both the October and November meetings.
- The OCR is too far above a neutral level, with the QSBO survey flagging the risk of weak inflation.
- Timings of 50bp moves are not a done deal, but we expect 125bp of cuts by February 2025 and a 4% OCR.

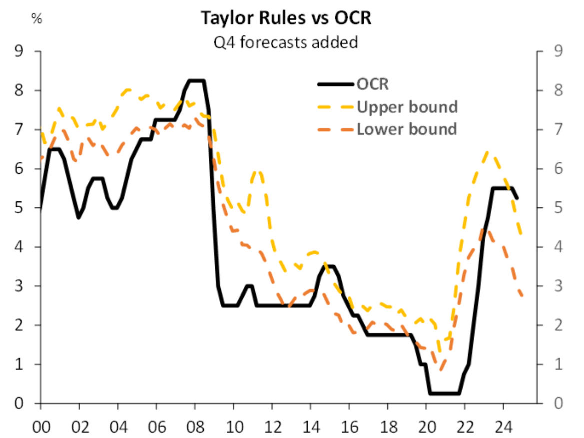
We expect the RBNZ will need to step up the pace of OCR cuts soon: we now forecast 50bp cuts at both the October and November OCR decisions. The exact timing of larger cuts is uncertain. October is not entirely a done deal, given it requires the RBNZ to heavily weight the NZIER's Q3 Quarterly Survey of Business Opinion results. Evidence of the need to step up the pace of cuts is likely to be stronger by November, after inflation and labour market data are out.

Why have we changed our mind? We are getting increasingly concerned by just how tight monetary conditions are, and how long they would remain restrictive if the RBNZ took a measured approach to easing. Inflation pressures look set to shrink very soon. The QSBO suggested that deterioration of the labour market has picked up steam and that pricing pressures have weakened considerably. It is a warning signal that inflation risks undershooting the 2% mid-point of the inflation target band. In contrast, the risk of high inflation proving to be sticky is much diminished.

Our previous OCR outlook didn't have the OCR returning to a neutral level until the second half of next year. A couple of 50bp cuts will speed up that journey. We expect the OCR will be down to 4% by February 2025. Subsequent OCR moves will be more heavily conditional on the economic outlook, but we have pencilled in a terminal rate of 3.25% from around mid-2025.

So far away

We are increasingly concerned that the OCR is very high relative to a more neutral level in an economy where inflation pressures and capacity have in effect already normalised. Our conclusion is the RBNZ will find that – at some point soon – it will need to speed up the pace of OCR cuts.



Source: RBNZ, Statistics NZ, ASB

Our ASB augmented Taylor Rule estimates for the appropriate OCR level suggest the OCR should be set well below its current level of 5.25%. The estimates point to OCR settings needing to be in a 2.75% to 4.25% range by the end of the year (given various estimates of neutral OCR settings and near-term forecasts for the unemployment rate and various inflation measures). Historically, our Taylor Rule has proved to be a useful indicator for monetary policy turning points and broadly tracks OCR cycles. The direction of this indicator is firmly down. What's more, cooling inflation and a likely decline in the neutral OCR going forward means that real interest rates and the degree of monetary policy restraint is likely to *increase* if OCR settings are not lowered, all else equal.

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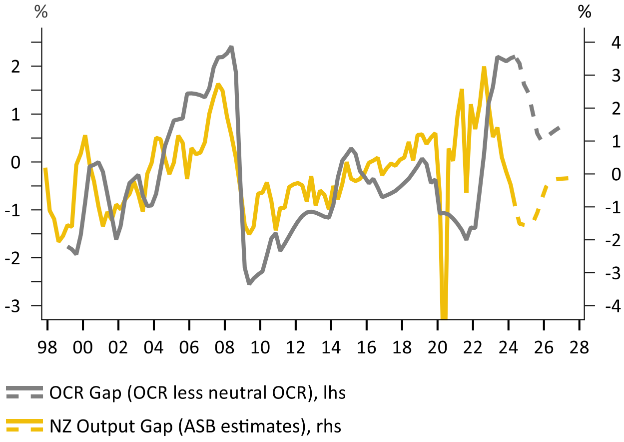
OCR settings are looking increasingly disconnected with the economic outlook. There is a positive relationship between capacity pressures in the economy (as proxied by the output gap) and the degree of interest rate restraint/support exerted on the economy (the gap between the current OCR vs. a neutral setting). At present there is a sizable disconnect, with still-tight monetary policy settings exerting a significantly contractionary impact on the economy. Moreover, looming fiscal tightening and rapidly-waning net migration will also weigh on demand.

Even with consecutive 25bp cuts per meeting this disconnect will remain, with monetary policy settings still looking to be too tight given the state of the economy. A faster pace of OCR cuts would help narrow the gap from both sides. Cutting the OCR earlier and by more will also likely reduce the amount of monetary easing needed overall, all else equal.

NZ Output Gap and Effective OCR

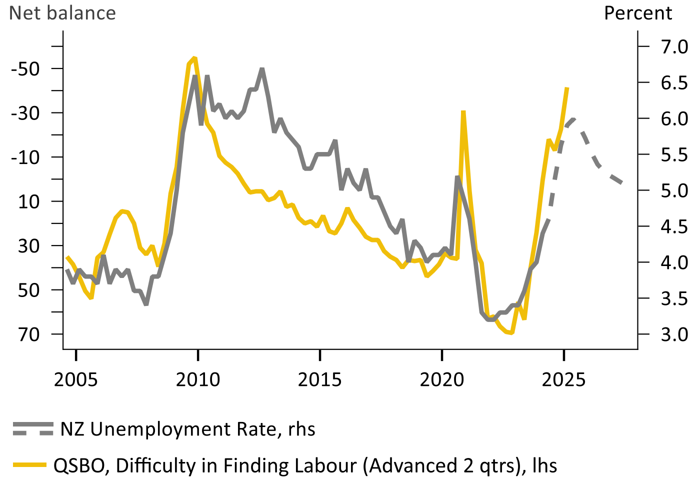


Source: Macrobond, ASB

Has the QSBO convinced the RBNZ?

To us, it is about when – not if – the RBNZ comes to this conclusion. The main jarring event has been the Q3 QSBO survey, with other developments largely in line with RBNZ expectations. The sobering parts of the QSBO survey were the continued deterioration in most of the labour market measures, and plunging results for experienced and expected pricing. The survey highlights the risks of higher unemployment, weaker wage pressures and weaker inflation outcomes than the RBNZ factored into its outlook. That should concern the RBNZ.

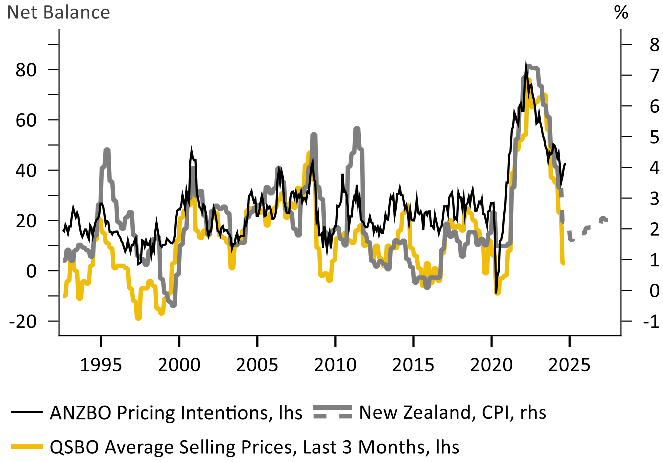
Difficulty Finding Labour & The Unemployment Rate



Source: Macrobond, ASB

A swifter pace of OCR cuts should help to reduce the economic damage to the labour market. While the current RBNZ remit has a sole inflation mandate, developments in the labour market have a key bearing on inflation. Furthermore, section 2ii of the Policy Remit requires the RBNZ to seek to avoid unnecessary instability in output, employment, interest rates and the exchange rate. Weak demand and acute pressures on profitability look set to lead to further job losses, with the unemployment rate on track to hit 6% by early next year, higher than the August MPS view (5.4% H1 2025 peak). The cooling labour market now points to the risk of core inflation falling below the inflation target midpoint, which should further shift the RBNZ's regrets analysis in favour of more pre-emptive monetary policy easing. We now have inflation undershooting the RBNZ's outlook, highlighting that inflation could at some point undershoot the mid-point of the target band. In short, the balance of risks has shifted further to the need for aggressively easing monetary conditions. Even if the RBNZ doesn't come to that conclusion for October, we think that the penny will drop in the November MPS.

NZ CPI Inflation and selling prices



Source: Macrobond, ASB

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