

New Zealand Economic Watch

RBNZ preview: High rates for longer

On hold again, but upside risk for inflation

The Reserve Bank of New Zealand (RBNZ) meets on August 16 and we expect rates on hold at 5.5% for a third consecutive meeting. Economic data has been mostly consistent with the Bank's expectations, reflecting traction from higher rates. Resilient consumers are now slowing down their spending and the unemployment rate has ticked up.

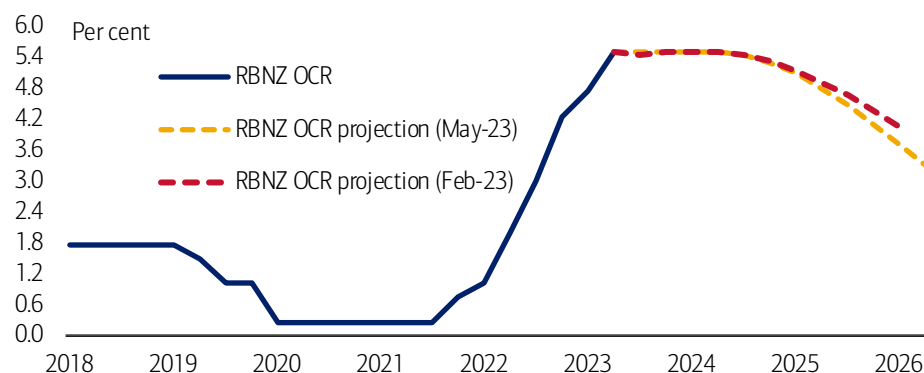
Leading indicators for construction remain soft, but there are some signs of a bottom with building permits coming back from very low levels as house prices rise. The nominal side of the economy remains the key uncertainty. While inflation has softened, the outlook for prices is mixed and we question how patient the RBNZ will be should prices remain high and persistent. Measures of inflation expectations for the two years ahead recorded a small rise.

A new OCR track and forecasts

The Monetary Policy Statement (MPS) will be released after the decision and focus will be on changes to the official cash rate (OCR) track. Currently, the Bank expects slightly lower rates from September 2024. Headline inflation is expected to fall within the 1-3% target range in the same quarter. Risks are evenly balanced as activity continues to slow domestically and globally, particularly in China. Meanwhile there is upside risk to inflation from both the non-tradables and tradables. We do not expect major changes to economic forecasts and the OCR. The RBNZ will likely retain its neutral/hawkish tone.

Exhibit 1: The OCR track

Should reflect the RBNZ's neutral/hawkish tone



Source: RBNZ

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NZD swaps have underperformed a rally in AUD 3y swaps since late July, cheapening on a cross-market basis by more than 35bps to 130bps. Given economic data has mostly met the RBNZ's expectations, we see an opportunity to receive NZD 2y IRS and pay AUD 3y IRS. The risk to the trade is that the belly also looks rich in both markets.

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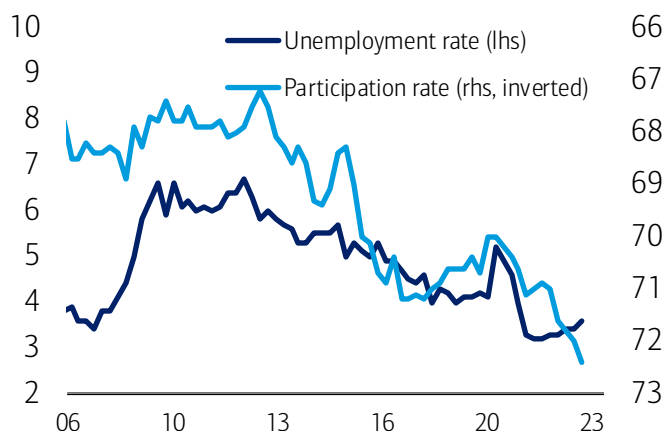
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Current conditions support a pause

At its latest meeting, the RBNZ highlighted the 5.5% level of the OCR was constraining spending and inflation and guidance suggested interest rates will remain high for “the foreseeable future” See: [Australia/New Zealand Watch: RBNZ review: High rates gain traction 12 July 2023](#). Employment was seen as “above its maximum sustainable level” back then, but 2Q employment outcomes reflected a slightly larger than expected rise in unemployment versus the RBNZ assumption, despite the ongoing strength in employment growth and participation (Exhibit 2). Leading indicators suggest labour market pressures are easing and vacancies declining, and the RBNZ’s current forecasts for unemployment shows ongoing rises ahead. Signs of easing pressures in the labour market supports the pause in August.

Exhibit 2: Unemployment ticks up

With record high participation

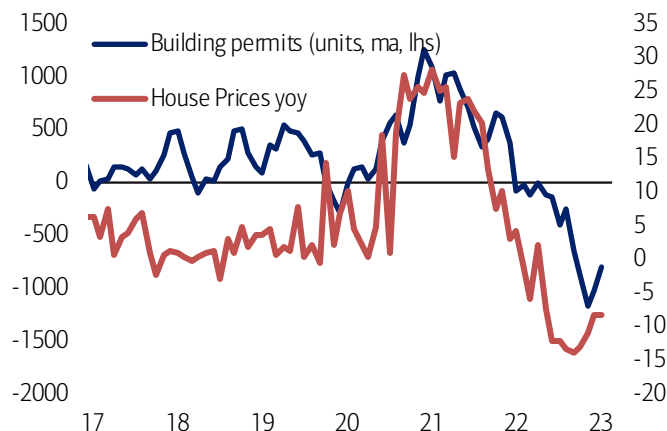


Source: StatsNZ

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Exhibit 3: Building permits and house prices rise

From very low levels



Source: Macrobond

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Some stabilisation in house prices combined with early signs of a turnaround in construction activity (Exhibit 3) mean expectations for an extended pause from the RBNZ could further improve the outlook for the housing sector. While it is too early to say, improved demographics are likely to support demand for housing, in our view. The RBNZ’s view is that higher interest rates continue to exert downward pressure on housing demand, but a sustained rise in house prices could increase financial stability risk.

Mixed economic conditions as well as some upside risk for inflation suggests the RBNZ is unlikely to turn dovish at this meeting. We think the RBNZ will keep rates unchanged at 5.5% for the remainder of the year. The aim would be to strike a balance between supporting growth and the labour market while ensuring inflation and inflation expectations continue to move towards the target range. The 1-year RBNZ survey of household inflation expectations, which has the best predictive power for the headline inflation recorded a small decline, which along with a rise in unemployment should be enough to keep rates unchanged for now.

What to watch

Food prices, home sales and net migration are the key releases ahead of the August meeting. Beyond August, the RBNZ has two Monetary Policy meetings left in 2023. These are in October and November. GDP data for 2Q will be released on Sep 21 and it is expected to print soft while CPI for the September quarter will be released just before the November meeting.

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