# New Zealand Watch

# RBNZ preview: Slowing down, but more work to do

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Economics
New Zealand

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## We expect the RBNZ to deliver a 25bp "hawkish" hike

The Reserve Bank of New Zealand (RBNZ) meets next Wednesday, 24 May. With the 1Q CPI print showing signs of stabilization, we expect the central bank to slow down its hiking pace and raise the Official Cash Rate (OCR) by 25bp to 5.5%. A downshift to a 25bp hike is also the overwhelming consensus among analysts, but bond markets are pricing in a 34bp increase. We agree that, if the RBNZ were to "surprise" the analyst consensus once again, a 50bp hike is much more likely than a pause.

Beyond the OCR decision itself, key to watch will be the RBNZ's tone around future rate hikes, and updated OCR projections in its May Monetary Policy Statement (MPS). Given that upside risks to the medium-term inflation outlook have risen over the past few months, we see a high probability that the RBNZ will revise up its peak OCR projection to at least 5.75% (vs. 5.5% previously), and possibly as high as 6%. Consistent with this, we also lift our terminal rate projection for NZ to 5.75% (vs. 5.5% previously) as we pencil in an additional 25bp hike in July. But the risks are clearly tilted to the upside, in our view. And we think that a cut is unlikely before 2H '24.

## April RBNZ recap & the RBNZ's inflation concerns

At its previous meeting in April, the RBNZ defied consensus expectations by sticking to its 50bp hiking pace (see RBNZ review: Go your own way, 5 April 2023). The summary record of meeting did note that the debate was between a 25bp vs. 50bp hike (compared to 50bp vs. 75bp in February). However, the Committee ultimately stuck with 50bp out of concern over:

1) Upside risks to inflation expectations from higher near-term prices of goods and services due to recent severe weather events in the North Island (floods/Cyclone Gabrielle).

2) The additional medium-term inflationary impact from rebuilding efforts in response to the floods/cyclone.

3) A premature easing of financial conditions, particularly the risk that declines in wholesale interest rates could feed through to lending rates faced by business and households.

## 1Q CPI confirmed easing of current price pressures

Since then, some of the more encouraging pieces of data for the RBNZ have been the 1Q CPI print as well as the RBNZ's latest quarterly Survey of Expectations.

The 1Q CPI report (published 20 April) showed headline inflation slowing to 1.2%QoQ, down from 1.4% in 4Q and 2.2% in 3Q (Exhibit 1). While the stickier non-tradables component remained elevated at 1.7%QoQ, this was actually slightly weaker than the 1.9% projection that the RBNZ penciled back in February (1Q CPI review: And now for the hard part, 20 April 2023). (continued)

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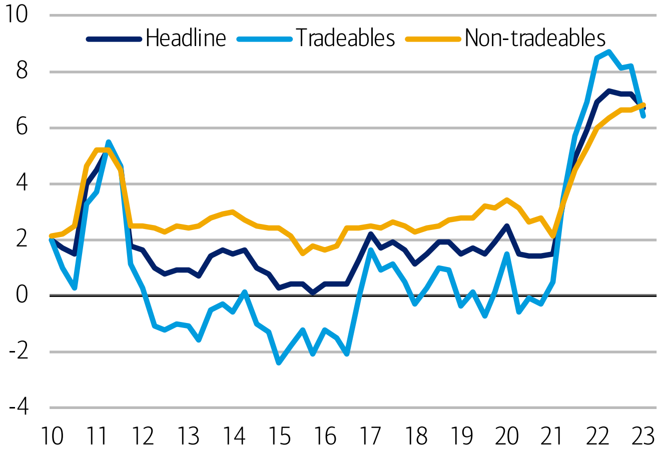
**Exhibit 1: New Zealand CPI %YoY**

The 1Q CPI report offered further evidence that inflation has peaked, though it remains much too high for the RBNZ's comfort




**Source:** Statistics New Zealand

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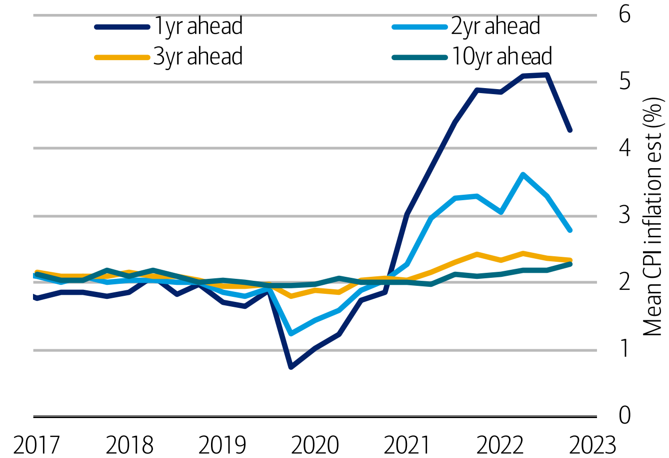
**Exhibit 2: RBNZ Survey of inflation expectations (Business)**

Short-term inflation expectations have started to decline following the surge in 2021




**Source:** RBNZ

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Meanwhile, the central bank's April Survey of Expectations (Business) showed that, not only do 5yr and 10yr-ahead inflation expectations remain within the 1-3% target band; near-term measures, such as 1yr and 2yr-ahead dropped quite sharply, to 4.3%, and 2.8%, respectively (Exhibit 2).

## But upside risks to medium-term inflation are growing…

The above data points confirm that New Zealand's inflation is past the peak. But more than any other DM central bank, the RBNZ remains concerned about the risks that high inflation becomes embedded. It is therefore much more focused on how quickly inflation returns to target.

In the February MPS, the RBNZ forecast headline inflation to decline to the upper band of its 1-3% CPI target in 3Q 24, and back to 2.1% in 2Q 25. However, in addition to the risks that the RBNZ flagged in its April policy meeting, developments over the past month point to further upward pressures to the medium-term inflation outlook:

**1) 1Q labour market data** (published 3 May) came in very strong: employment grew 0.8%QoQ (2.5%YoY) while the unemployment rate remained near record-low levels, at 3.4%. (Exhibit 3) Both point to a tighter labor market than the RBNZ had assumed in the February MPS, despite a solid pick-up in labor supply.

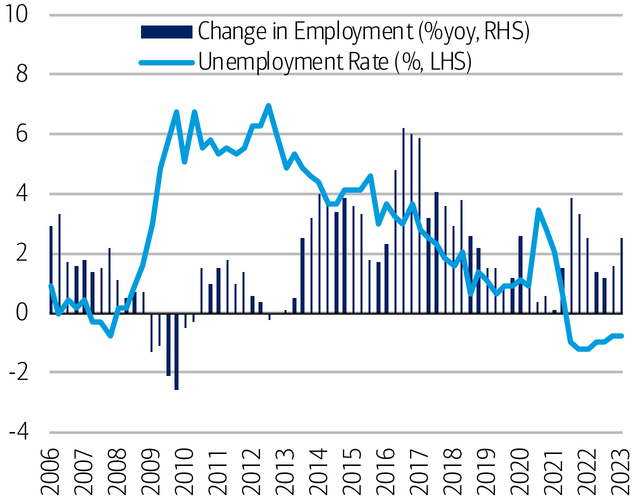
**2) 1Q wage data** (published 3 May) were more mixed, with growth in the private sector Labour Cost Index (LCI) slowing to 0.9%QoQ—softer than the 1.1% expected by the RBNZ and consensus.

However, 1Q private sector average hourly earnings in the Quarterly Employment Survey (QES), which better captures pay that workers receive in hand, surprised on the upside, jumping 2.1%QoQ or 8.2% on an annual basis. This defied the RBNZ's expectation of a slowdown to 7.6% in the February MPS.

3) Meanwhile, **net migration** gains eased slightly in March, but remained incredibly elevated at 12.1K SA, for a quarterly total of 32.4K. This remains well above the RBNZ's estimates in the February MPS (Exhibit 4). While increased net migration could help ease labor shortages in the long run, the RBNZ has been clear that it sees it as inflationary on net over the medium-term, given increased demand for housing and other goods and services.

**Exhibit 3: New Zealand employment growth and unemployment rate**

Employment jumped strongly in 1Q while unemployment remains at record lows




**Source:** Statistics New Zealand

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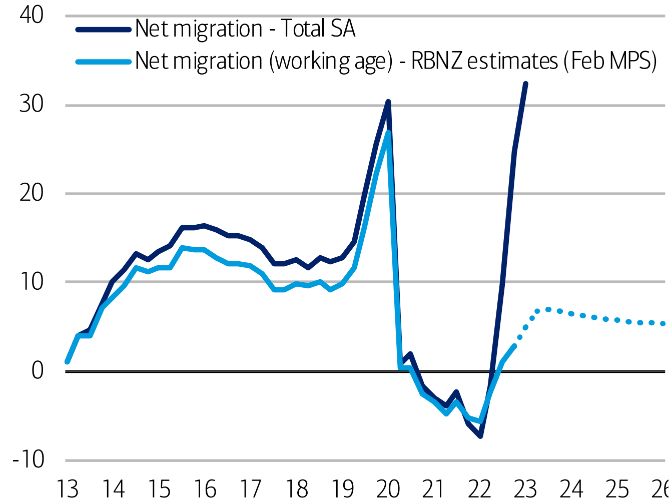
**Exhibit 4: New Zealand - monthly net migration ('000 persons, SA)**

The pick-up in net migration is running well ahead of the RBNZ's forecasts




**Source:** Stats NZ, RBNZ

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4) And then there is the **2023 budget**, which the Treasury delivered earlier this week. As our rates strategist, Oliver Levingston discusses below, the latest budget increases the funding task by a higher-than-expected NZD 20bn. The increase in the fiscal impulse will be inflationary, which the RBNZ will likely want to address with more rate hikes.

## …pointing to the need for a higher terminal rate

Putting everything together, there are more reasons for the RBNZ to continue hiking than there were in April. That makes the decision on whether the RBNZ will go with another 50bp hike, or downshift to 25bp, a closer call than the consensus suggests.

However, with the policy rate in restrictive territory and the 1Q CPI data offering some good news, we think the RBNZ will shift towards a strategy of delivering smaller hikes until it is confident that medium-term inflation risks have subsided.

Indeed, at this stage in the cycle this may be more effective than surprising the markets with large-sized hikes: another 50bp hike, for example, may result in heightened concerns of policy overkill and recession, causing markets to price in earlier cuts. This would put downward pressure on medium-term interest rates, resulting in the premature easing of financial conditions that the RBNZ explicitly flagged as a worry in April.

Put differently, a 25bp "hawkish" hike, with a clear indication of willingness to do more (via a higher terminal rate projection) may prove more effective in keeping wholesale interest rates higher for longer.

## Change in OCR call – higher terminal & later cuts

The boost from fiscal stimulus and the Cyclone rebuild also prompts us to pencil in stronger growth in 1H 23 and later recession, which we now think will not start until 3Q 23 (Exhibit 5). As a result, we think inflation will be slower to come down and, like the RBNZ, do not see headline CPI returning to the upper limit of the central bank's target band—or 3%YoY—until 3Q 24.

Therefore, in addition to raising our forecast for the RBNZ terminal rate to 5.75%, we push back the timing of expected cuts to July 2024, from February 2024 previously.

**Exhibit 5: BofA New Zealand forecasts (new vs. old)**
We expect higher terminal rate & for cuts to start later than previously expected

| | 2022 | 2023 | 2024 |
|---|---|---|---|
| Real GDP %YoY (avg.) | 2.5 | 0.9 | -0.5 |
| Old | 2.5 | 0.5 | -0.4 |
| Headline CPI %YoY (avg.) | 7.2 | 6.2 | 3.4 |
| Old | 7.2 | 6.3 | 3.2 |
| Unemployment rate % (avg.) | 3.3 | 3.8 | 5.2 |
| Old | 3.3 | 4.2 | 5.5 |
| Policy rate % (e.o.p.) | 4.25 | 5.75 | 4.75 |
| Old | 4.25 | 5.5 | 3.75 |

**Source:** BofA Global Research

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**Exhibit 6: New Zealand: Upcoming key releases**
The 2Q CPI report (due 19 July) will be critical in determining whether the RBNZ can pause hikes from August

| | |
|---|---|
| **24-May** | **RBNZ OCR decision & MPS** |
| 2-Jun | Terms of Trade (1Q) |
| **15-Jun** | **GDP (1Q)** |
| 22-Jun | Trade balance (May) |
| **12-Jul** | **RBNZ OCR decision** |
| **19-Jul** | **CPI (2Q)** |
| 24-Jul | Trade balance (Jun) |
| **2-Aug** | **Employment & Wages (2Q)** |
| **16-Aug** | **RBNZ OCR decision & MPS** |
| 21-Aug | Trade balance (Jul) |
| 4-Sep | Terms of Trade (2Q) |
| **21-Sep** | **GDP (2Q)** |

**Source:** BofA Global Research, Bloomberg

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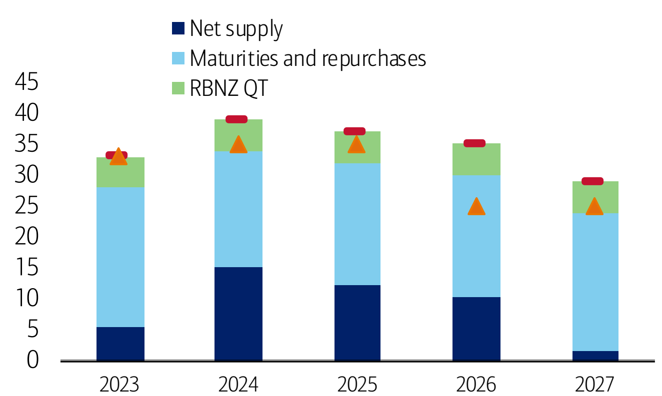
## Rates and bond supply

The NZ Treasury handed down its annual budget and the higher fiscal impulse supports our economists' call for a higher terminal rate. While supply for 2022/23 has remained unchanged, NZ Debt Management's funding task has increased by NZD 20bn over the forward estimates with the largest increase in 2025/26 (Exhibit 7). Given that NZD 1.1bn was committed to the Cyclone rebuild, an increase in deficit financing of NZD 20bn over the forward estimates is primarily attributable to other spending, including cost of living relief. The NZ Treasury has also revised up their GDP forecasts since the Half Year Economic and Fiscal Update 2022. The NZ Treasury no longer forecasts a recession and instead expects a more moderate slowdown in activity over the next 12 months with growth slowing to 1.0% in 2023/24.

Given negative carry and roll on AU/ NZ cross-market expressions, we expressed a preference for US-NZ and CA-NZ cross-market IRS (interest-rate swap) spread tighteners in a note at the end of last month (New Zealand Rates Watch: Kiwi convergence: cross-market spreads to compress as NZ outlook dims 28 April 2023). At present, cross-market spreads to the US are pricing a much more aggressive policy path for the RBNZ (Exhibit 8). Yet, while a post budget sell-off in NZ 2y IRS has fuelled additional widening on a cross-market basis, the moves are somewhat justified given that the size of the positive fiscal impulse has introduced the risk that the RBNZ will choose to counteract fiscal stimulus. As foreshadowed in April, we recommend waiting until after the RBNZ meeting on 24 May to add risk.

**Exhibit 7: NZ funding task rises**
Bond supply to rise, especially at the back end of the forward estimates




**Source:** BofA Global Research, Bloomberg

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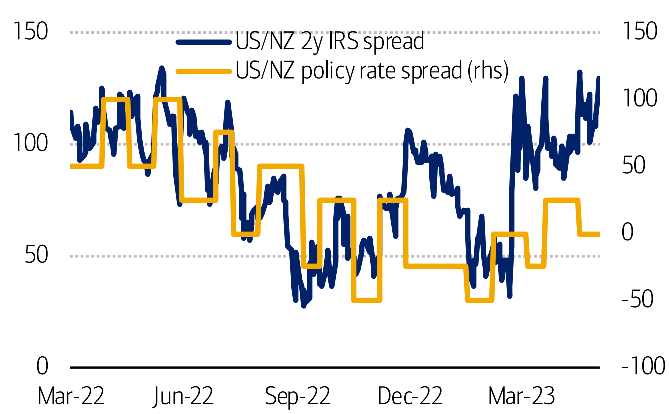
**Exhibit 8: US/NZ cross-market 2y IRS spreads widen again**
Post-budget cheapening of NZ 2y IRS has led spreads wider

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