ASB

# Economic Note

RBNZ May Monetary Policy Statement Preview

19 May 2023

## More people, more fiscal, big hike?

- **We expect the RBNZ to lift the OCR a final 50bp in May** to 5.75% and flag the risk of a further hike.
- Inflation has peaked. But fiscal spending is keeping up the heat, and the RBNZ's response to migration is also key.
- The market is appropriately pricing in over 50bp of hikes, but appears too ahead of itself in pricing in rate cuts.

The impending RBNZ Monetary Policy Statement now looks more on a knife edge. We had previously thought that the RBNZ would do a final 25bp increase on May 24. **Post-Budget, we now expect a 50bp lift in May.** We think that will be it, but that the RBNZ will flag the risk of a further hike.

There is an evident turning in inflation pressure and lagged monetary policy impacts that are yet to come through. But there are two added flies in the inflation ointment: fiscal pressures and the uncertain inflation impact of migration.

The recent Budget opens up the fiscal taps more than what we had expected, notwithstanding the given of added disaster recovery spending. The fiscal impulse (impact on economic growth from the fiscal stance) is now set to be quite stimulatory at a time when the RBNZ is still trying to lean against inflation.

Furthermore, the future path of the OCR is going to depend a lot on how migration flows evolve and how the RBNZ assumes they will influence inflation. Reported net inbound migration has been strong and revised up, changing the picture considerably in a short space of time. There will be lot more people available to work, relieving acute labour market pressures quicker. But that also means a lot more people who will spend and need somewhere to live.

The orthodox thinking on migration is that overall it adds to inflation pressure. We aren't as convinced that will be the case this time, particularly as labour shortages have played a significant role in boosting recent inflation pressures. But right now it's the RBNZ take that matters. Watch for whether the RBNZ sees migration as overall reducing inflation pressures – or boosting them.

A 50bp increase is not a done deal, and the RBNZ could still do a 'hawkish' 25bp lift. Market pricing of the OCR is already roughly 50:50 between a 25bp and 50bp increase in May and is pricing in an OCR peak above 5.75%. At the margin that could further tip the RBNZ to a 50bp hike to prop up term rates: market pricing of OCR *cuts* is premature in the RBNZ's eyes. The Statement and subsequent media conference are likely to be very clear that high interest rates will need to be sustained for some time yet.

### Signs that inflation is finally turning

It's been more than 18 months since the RBNZ first lifted the OCR. We are now seeing early signs that inflation pressures are starting to ease, including:

- Private consumption and housing construction volumes are flat/down, indicating that interest rates are restraining activity.
- Headline inflation in Q1 not only fell – but at 6.7% yoy it was also significantly lower than expected.

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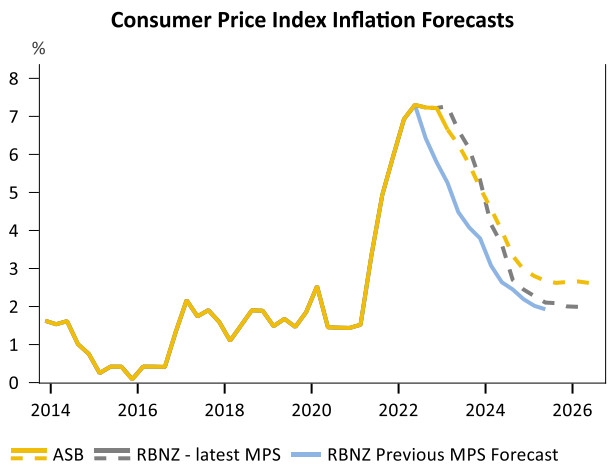
- CPI housing construction cost inflation has eased markedly (though is still high and could yet get held up by disaster recovery cost pressures).
- To date, the more immediate inflationary impacts of the earlier weather events have been milder than anticipated.
- Wage growth in Q1 didn't pick up quite as much as expected.
- Inflation expectations have fallen sharply from last year's peak.

The RBNZ will get further help through a substantial pipeline of lagged tightening to come into effect, predominantly on households. The average mortgage rate being paid by households is around 4.7% at present and is likely to peak near 6% around the end of this year.



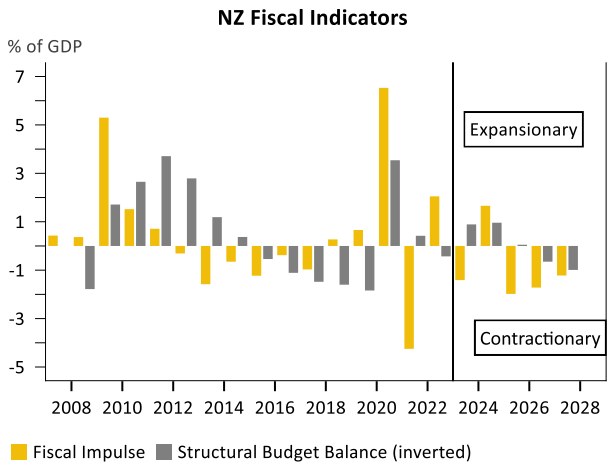

Source: Macrobond, ASB

However, the RBNZ will remain wary that inflation is likely to prove sticky. And in April it evidently viewed the disaster recovery impacts on inflation as more inflationary than in its initial February assessment.

## Budget leaves RBNZ singing solo

From time to time you hear the phrase "monetary policy needs mates" i.e. co-ordinated fiscal policy can help the RBNZ more easily achieve its job. As far as the Budget goes, Adrian Orr looks like he will be singing a solo rendition of "With A Little Help From My Friends" in the Policy Karaoke Bar.

The fiscal impulse (fiscal policy's impact on economic growth) has switched in the June 2024 year from being contractionary to quite expansionary. That is right when the RBNZ is still leaning hard against inflation pressures. Moreover, government debt issuance has jumped by a lot more than we were expecting to finance added spending. The RBNZ is likely to assess it needs to lean that much harder against inflation.

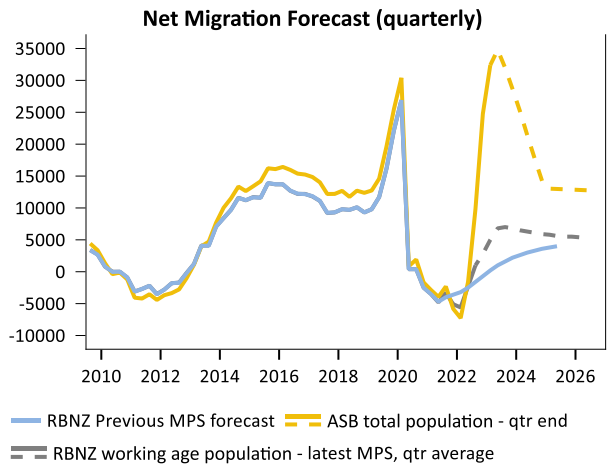



Source: Macrobond, ASB

## Migration: help or hindrance?

A really important dimension of the RBNZ's decision-making is the rapidly-changing migration picture – both recent movements and their implications for the future. Reported migration has been strong – and often revised up in short order. Six months ago, we expected an eventual 20,000 peak annual net inflow of migrants. We now expect an earlier peak of above 100,000 (which is merely the pace of recent months' movements).

The economic implications of this sharp (and to some extent, unexpected) lift in migration are quite significant. NZ is getting a sharp boost in people available to work –




Source: Macrobond, ASB

at a time when labour shortages have been persistent. But it's also a boost to demand, as all these new arrivals need food, clothes, homewares and somewhere to live.

The RBNZ's traditional thinking on migration's influence on inflation has been that the demand wave comes before the supply benefit, and to treat a migration boom as something to lean against. Yet the current circumstances look a little different to past migration booms. The supply of people is arriving at a time of strong wage growth and just as employment is set to cool off. And the spending brakes are already hard on in terms of still-high inflation eating into pay packets, high borrowing costs, and a housing market that is currently in the doldrums.

We aren't convinced that the migration boom automatically heralds another inflation headache. But only time will tell. Right now, the RBNZ may stick with the view that migration is likely to overall be inflationary, and act accordingly in the short term. Longer term, the data will show us how migration is shaping inflation, which will influence the timing and pace of the eventual easing cycle.

## What to expect in the MPS

The RBNZ will be very mindful that it is a long way from achieving its inflation target, and the tone of the Statement will reflect that. We expect the RBNZ's forecasts and messages to make it clear that pausing was never a real consideration for this meeting and that further tightening is a real possibility. The other impression the RBNZ will want to make is that getting inflation firmly under control will require interest rates to be held at a high level for longer than financial markets are currently pricing in.

In the forecasts we expect to see:

- A weaker inflation forecast over 2023 than was the case in February but probably little change to the 2024 outlook;
- Faster population growth, potentially higher unemployment forecasts, slightly quicker moderation in wage growth;
- Weaker GDP for the March 2023 year (reflecting the recent loss of momentum vs. the February forecasts) but stronger March 2025 growth (reflecting stronger population growth);
- An OCR that peaks above 5.75% and holds up for longer than in the February MPS.

We expect the policy assessment and record of meeting to:

- Note that even though inflation has eased, it remains (too) high and persistent;
- Show the decision was a debate between a 25bp and 50bp increase, with a pause never under serious consideration;
- Emphasise that monetary conditions need to remain tight for an extended period in order to ensure inflation gets back into the target band;
- Restate that the RBNZ expects to see continued moderation in activity and inflation, and that "the extent of this moderation will determine the direction of future monetary policy".

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