Economy Watch

30 January 2024

RBNZ Sticks To Its Guns

- **RBNZ downplays downward growth revisions**
- **RBNZ downplays low inflation read**
- **RBNZ focuses on heightened migration**
- **RBNZ focuses on non-tradables inflation**
- **Messages fall on deaf ears**

Today's speech by Paul Conway was long awaited for any insight it might provide into the way the RBNZ's forecasting team is thinking about recent data and how that might impact its February 28 Monetary Policy decision. As it turned out, there was a very clear message: based on the information it currently has, the forecasting team thinks there is little reason for it to change its monetary policy stance.

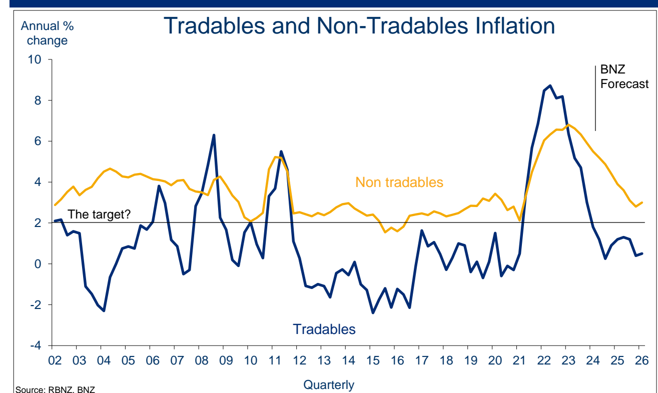
We note that the speech was the view of one person, it does not necessarily reflect the views of the Monetary Policy Committee (MPC), and that same MPC has not yet met in advance of the upcoming Monetary Policy Statement. But it would be fair to assume that what was said today will be the same advice as presented to the MPC when the time comes. Moreover, one can't help but think the comments were a clear warning to markets not to get ahead of themselves.

Conway did acknowledge GDP had been revised significantly lower, and that headline inflation was lower than expected, but then went on to completely downplay these factors. Take these comments by example:

- Recent GDP revisions do not necessarily mean that capacity pressures in the economy are much lower than assumed.
- Private demand in the economy, which is more interest-rate sensitive, has mostly been revised up, with stronger consumption and investment than first reported. In fact, levels of consumption and investment in the third quarter 2023 GDP numbers are almost exactly as estimated in the November Statement.
- While GDP has been revised down, net inward migration continues to be revised up.
- Annual non-tradable inflation, which is a rough approximation of inflation generated within the New Zealand economy, came in at 5.9%, which is higher than we estimated.
- We still have a way to go to get inflation back to the target midpoint.

We've said this many times before but, to reiterate, our biggest concern is the Bank's apparent fixation with non-tradables. This was reinforced by Conway's comment that "non-tradables inflation is a long way from 2.0%". It certainly is, at 5.9%, but non-tradables inflation is almost always higher than 2.0%. Since 2000 non-tradables inflation has averaged 3.3%. In the 95 quarters across this period annual non-tradables inflation has been 2.0% or below just 6 times. Four of those six quarters ended up sub 2.0% because of a big reduction in ACC levies that "artificially" depressed the reading by around 0.6%.

The non-tradables conundrum



Given what is currently driving non-tradables inflation, it is highly unlikely monetary policy will be able to get it anywhere near 2.0% in the foreseeable future. In the last twelve months major contributions have come from: cigarettes and tobacco +11.5%, property rates and related services 9.6%, household energy +5.9%, out-patient services 5.8%, hospital services 12.9%, education 4.4% and insurance 11.9%.

The RBNZ contests that its modelling shows non-tradables inflation is interest sensitive. This may well have been the case in the past but a significant proportion of today's inflationary pressure will not be so.

A substantial proportion of current non-tradables inflation can be attributed to four factors, which are in some cases inter-related:

- local and central government charges
- the country's infrastructure deficit
- the impact of climate change and
- increased insurance claims for natural disasters.

The other factor, at play, is population growth and its impact on housing and local government costs.

The RBNZ's actions can do little in this space but act as a barrier to second-round effects.

- The Bank can warn government about its policy impacts on inflation but can't direct policy
- Monetary policy will not quickly address global warming issues
- It won't improve the weather
- It won't fix Wellington, or anyone else's, water problems
- It won't curtail population growth.

In the recent past our get out of gaol free card has been that we have operated in a world where disinflationary pressures dominated in the tradables' goods prices space. Tradables inflation over the last two decades has averaged 1.2%. The problem is, and Conway highlighted this, that those things that drove tradables inflation lower are now in reverse.

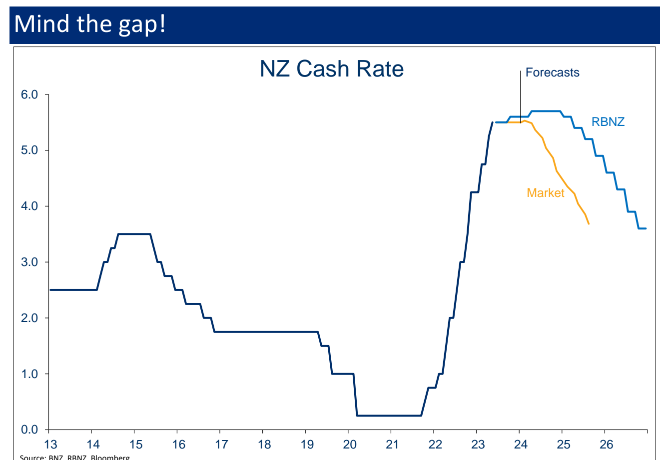
The Bank's view is that this means non-tradables will need to play a bigger role in getting headline inflation down. But given the headwinds to this over the next few years, we would like to think that a better approach would be to simply be less dogmatic about getting inflation to the mid-point of the target band. Alan Bollard, when he was central bank governor was much more relaxed about using the full width of the band. This didn't seem to cause too much problem.

And, anyway, even were we to be dogmatic about targeting a mid-point, we have yet to hear a good argument as to why we should be confident that 2.0% is the optimal number. As a point of contrast, if inflation was forecast to be 2.25% in both New Zealand and Australia the RBNZ would be running tight monetary policy and the RBA loose. Which Bank would be right?

All that said, it doesn't really matter what we think about the appropriateness or otherwise of monetary policy settings. The best that we can do is read the RBNZ's tea leaves and try to work out what it is going to do. With this in mind, and based on current information, it would seem to us that the Bank's economics team will be strongly advising the Monetary Policy Committee, when it discusses its February MPS, that it should maintain a very similar stance to that which it published when it produced its November instalment. That means limited inclination to cut rates until the second half of 2025 with an even to greater-than-even possibility of a further rate hike. This is a clear warning to financial markets that their pricing of at least three rate cuts this year is inappropriate.

Interestingly, financial markets completely ignored that warning today with pricing much the same after the speech as before. Hopefully, this does not act as a red rag to the RBNZ bull and tip the Bank into action just to make a point. This certainly cannot be ruled out. Indeed, while we are forecasting the RBNZ to stand pat in February you'd have to say that the chances of a hike are much greater than the zero chance of a February cut.

Mind the gap!



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