Research

Economy Watch

6 August 2024

August MPS Preview

- **Easing already overdue**
- **We call for an immediate rate cut**
- **The economy is buckling, inflation is controlled**
- **A delay risks unnecessary volatility in output and interest rates**
- **Recent RBNZ view swings provide consternation**

The New Zealand economy is buckling under the pressure of extremely tight monetary conditions, slumping net migration, government cutbacks, rising unemployment, reduced investment activity and weak confidence.

In the last month alone we have learnt that:

- The Performance of Manufacturing Index slumped to 41.1 with its key components falling to GFC levels.
- The Performance of Services Index was even lower at 40.2, the lowest non-COVID indicator in the history of the survey which began in 2007.
- Retail electronic card transactions fell 0.6% in June to be 4.4% down on year earlier levels – in nominal terms!
- Trade figures showed a sharp annual decline in the import of plant and machinery equipment and consumption goods reflecting a weakening domestic economy.
- June month, and quarter, filled jobs declined.
- Job ads slumped further, down 12.5% in Q2 and 32% on an annual basis.
- The ANZ Business Opinion Survey held its ground but was still indicative of a struggling economy.
- Residential building consents dropped an annual 36% in June.
- Net migration inflows fell markedly.

Meanwhile, business profitability is coming under extreme pressure as rising input costs can no longer be passed on through heightened selling prices. This is a general theme but, in particular, we are getting increasingly concerned about what the rising cost of energy is doing to increasingly marginalised energy intensive industries. Additionally, we are seeing pressure on sectors that have, until recently, been doing relatively okay such as, for example, the accommodation sector with Hotel Data NZ reporting that revenue per available room fell an annual 36.2% in Wellington in July and 20.9% for Auckland.

Add to this falling global commodity prices, more weak data out of China, offshore central banks moving to more dovish stances and the heightened threat of war in the Middle East and it all looks very ugly.

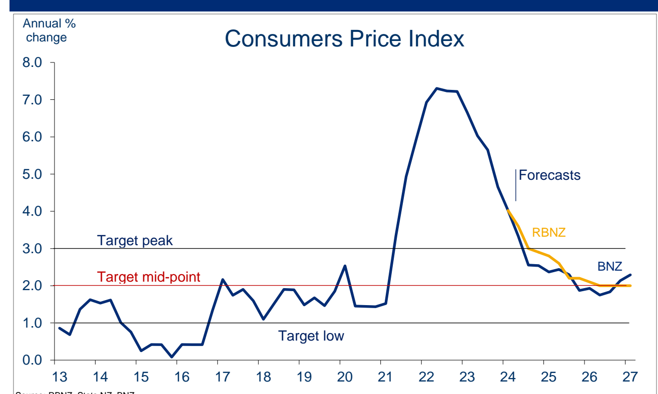
From the RBNZ's perspective, none of this matters if inflation is not behaving itself but it is. Headline inflation for the June Quarter, and year, came in 0.3% lower than the RBNZ anticipated, and all measures of core inflation continued their downward trend. Moreover, with the economy imploding inflation must surely continue to fall.

Given all the above we strongly believe the Reserve Bank should be easing monetary policy as soon as possible. Indeed, we are on record as having said that it should already have done so. Given the lags between rate moves and their impact on the economy, and the current parlous state of New Zealand, we strongly advocate that the Bank starts a progressive easing cycle from the August meeting.

We have long argued the Bank would probably not cut rates until it had seen annual headline inflation within its 1.0% to 3.0% target band. We thought that would be achieved with the release of the Q3 CPI, to be released in October, allowing a November first cut. For some time, the Reserve Bank had expressed concern that inflation might not get within the band so hard evidence was needed.

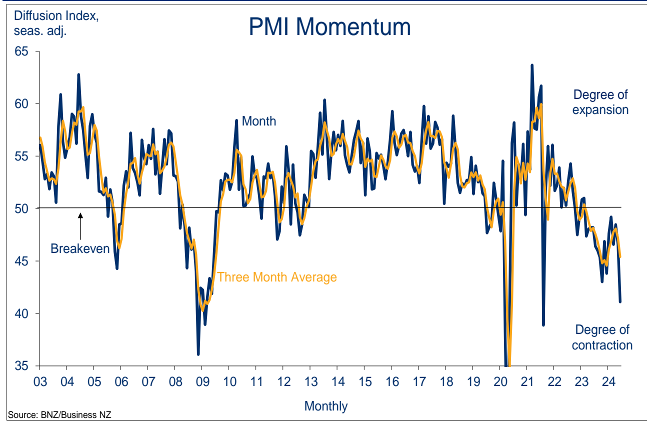
But the Bank's tone changed markedly with its July Monetary Policy Review (MPR) in which it said, "the committee is confident that inflation will return to within its 1-3 precent target range over the second half of 2024". Given that, and the lower than anticipated Q2 CPI, there is no need to wait for confirmation.

Inflation sorted

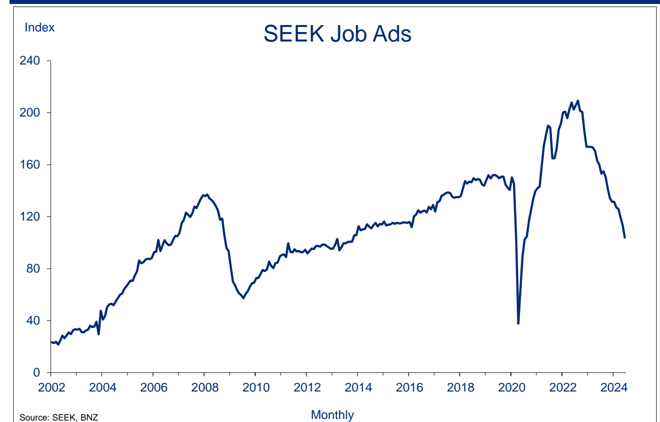


Enough is enough

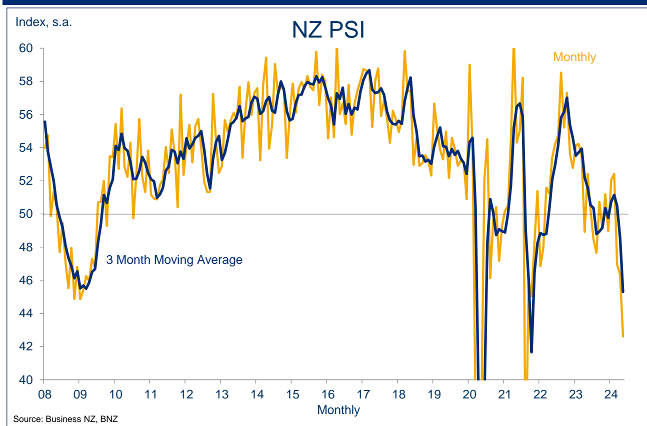
Manufacturing slumps



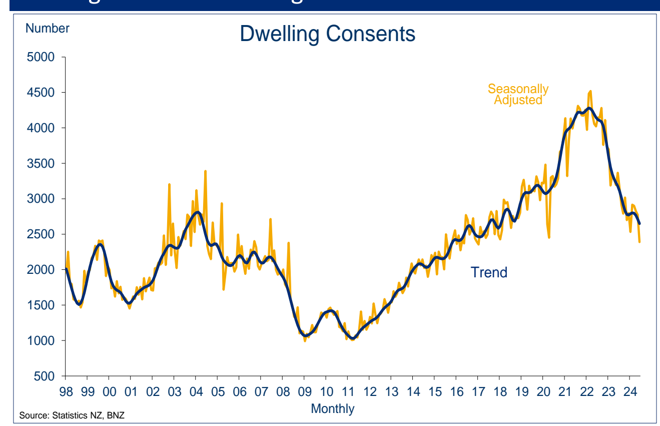
Job ads plummet



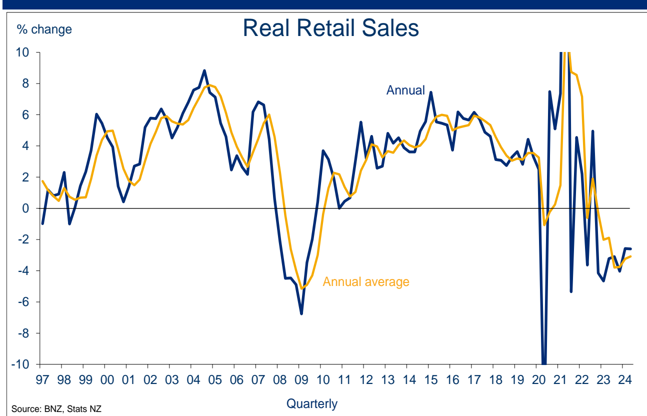
Services capitulate



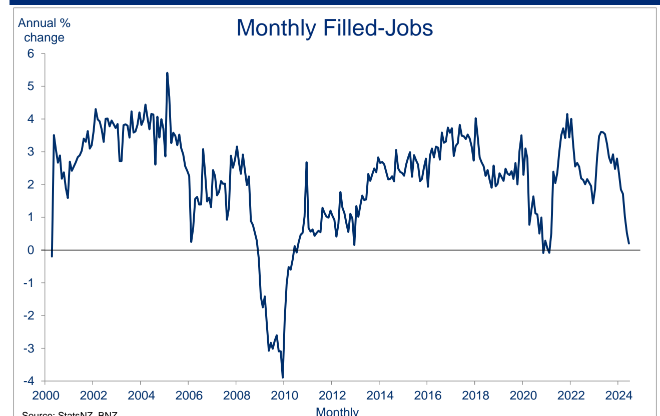
Building sector contracting



Retail awful



Job growth gone



That said, non-tradables inflation again surprised to the upside, by 0.1%. Given past RBNZ focus on this measure it is right to consider this a potential sticking point for the Bank. But here again the July MPR is worth reconsidering in that the Bank noted: “Domestic inflation measures remain more persistent, but growing excess capacity in the domestic economy provides greater certainty that they will sustainably decline”. “Certainty” and “will” suggest the Bank will look through this non-tradables issue. Moreover, we believe the amount of spare capacity in the economy is now greater than what the RBNZ assumed when it put together its May Monetary Policy Statement (MPS). At that time it was forecasting Q2 GDP to be +0.1%, we think that number is more likely to be negative.

All this leaves us with a dilemma. Do we forecast the RBNZ to do what we believe is “right” or do we try to second guess them?

There are some things we can say with a reasonable degree of certainty:

- The Reserve Bank will remove the near-term tightening bias from its forecast rate track and replace it with an easing bias.
- The first rate cut will be brought forward substantially.
- The OCR track will bottom out at 3.0% or lower.

What we are less certain of is when will the first rate cut be and how aggressive will be the forward track.

In our opinion, the RBNZ has two choices: cut now and build in progressive rate cuts thereafter or wait and, ultimately, risk being forced into a 50 basis point cut in November. We think it unlikely that the easing cycle would commence in October.

In its July MPR the RBNZ said, in reference to the state of monetary conditions, that the “extent of this restraint will be tempered over time consistent with the expected decline in inflation pressures”. “Tempered” to us implies steady and guarded rather than knee-jerk hence, our expectation of an earlier and more regular move than a panicked late response.

One way or another, we feel more confident with the view that the cash rate will be 100 basis points lower by February of next year than we do with the expectation that the bank will pull the trigger in August.

We’d have been quite confident about August had it not been for the RBNZ’s tilt to a tightening bias back in May. That shift completely threw us as we could see no justification for it. The reversal of that view in July seemed sensible and we can only assume that in the course of time the RBNZ will see the May shift as a mistake. Be that as it may, the Bank’s propensity to surprise leaves us with a huge degree of nervousness about our call. With that in mind, we note the RBNZ’s focus on productivity in its latest MPS. Its concern about declining productivity was a key element in its hawkish tilt and there’s a good chance that productivity has fallen again.

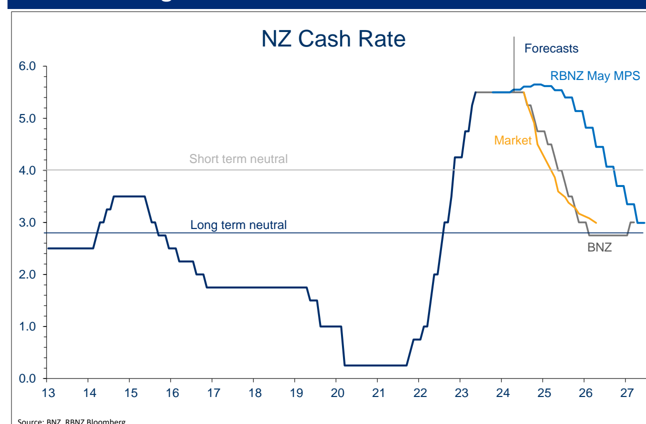
Putting all this together we are, with great trepidation but with a strong sense of what is appropriate, shifting our expected first rate cut from November to August with consecutive rate cuts thereafter heading to an unchanged low of 2.75%.

The central bank is supposed to take into consideration the minimisation of volatility in output and interest rates when setting policy. To delay cutting much longer risks maximising such volatility.

Ironically, while our call may seem a tad aggressive it’s not as aggressive as the market is currently pricing. The market currently has 100 basis points of cuts by November compared to our 75. We think this unlikely.

We doubt the RBNZ will want the market to rally any more than it currently has so don’t be surprised if the interest rate track it publishes is higher than the eventual rate outcome. At the same time, any suggestion by the Bank that it will not be moving any time soon is likely to be met with derision by markets which will likely reprice the near term but build in more aggressive cuts further down the track.

Time for change



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