# ECONOMIC BULLETIN

## Hawks, doves, and kiwis.

2 May 2024 | **Westpac Economics Team** | **westpac.co.nz/economics** | economics@westpac.co.nz
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### Overview.

Financial markets and economic commentators' views have continued to fluctuate in the three months since we last produced this "Hawks and Doves" note.

Despite concerns that the RBNZ's hawks might reemerge at the release of the February Monetary Policy Statement and push the OCR to a new cycle high, the cooler-headed doves held the day and left the RBNZ very comfortable with leaving the OCR where it is until 2025.

However, markets have, until quite recently, been hankering for an earlier dovish tilt relative to the RBNZ's position and the views of most domestic economists. The New Zealand doves continued to take their lead from the global doves who generally feel strongly that other advanced economy central banks will change tack and cut rates significantly over 2024. If the RBNZ was among the first to raise rates, then surely, they must be among the first to cut them… right? Fuel for the New Zealand dove's view have been the ongoing indicators of weak demand in New Zealand which drove hopes that inflation would soon fall, taking the RBNZ's OCR with it. Some commentators even discussed a chance of a rate cut by August and a decisive dovish tilt in the April and May RBNZ meetings.

More recently, reality came crashing down as New Zealand inflation data show that the path back to 2% inflation will be a long one. In addition, inflation dynamics among key peer economies such as Australia and the U.S. suggest that we may not be returning to the salad days of "immaculate disinflation" that we saw in the previous decade (i.e. disinflation while strong growth continued). Rate cuts in some important foreign jurisdictions seem less assured, and the prospect of rate hikes is even creeping back into the lexicon. Hence the hawks have started to regain the initiative.

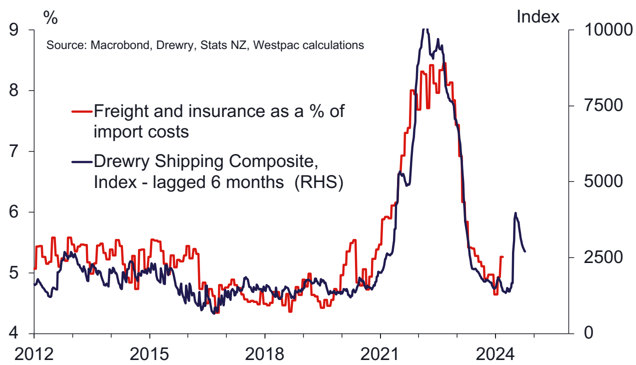
So, with arguments on both sides, the Westpac Economics team has again been considering how the outlook for monetary policy might evolve over the coming year or so. To help organise our thoughts and promote debate, we have marshalled a range of hawkish and dovish considerations that, while not exhaustive, might be debated by those driving the future direction of policy and those preparing to deal with it in their businesses. As always, we invite feedback on the perspectives we discuss here and any additional relevant viewpoints.

### The Hawk's Eye View.

Global conditions won't have the same inflation dampening impact going forward as we saw over the past year.

- Global tensions risk pushing oil prices higher.
- The NZD has lost ground. In addition, it looks like the Fed and other central banks will ease later than previously assumed, which could add to the downwards pressure on the Kiwi.
- While the easing in global supply chains pulled down inflation over the past year, that dynamic has largely run its course.

**Global shipping costs versus New Zealand shipping costs**

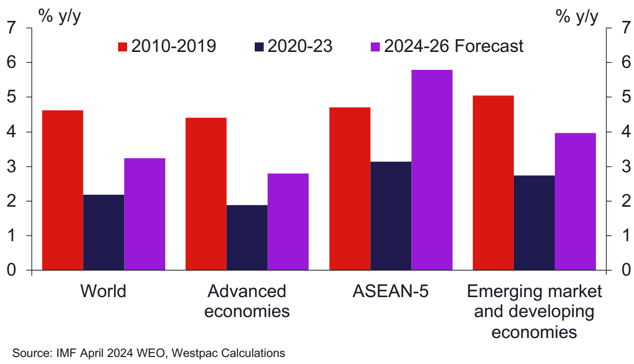



A global upturn is coming before inflation has normalised.

- Emerging market economies are starting to strengthen, partially driven by early policy easing.

- A recovery in world trade is underway which could signal a revival in commodity prices that boost NZ incomes and growth.

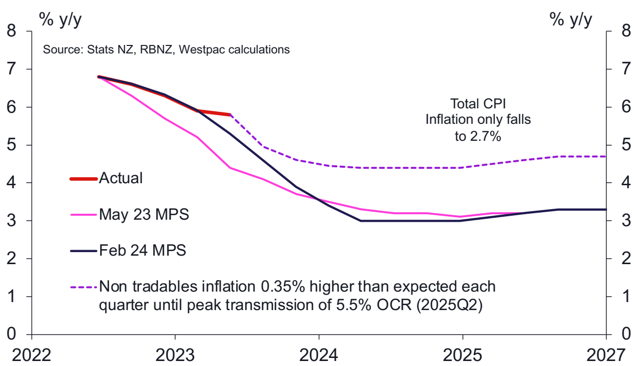
**Global export growth is recovering**




Inflation is not normalising quickly enough to re-anchor inflation expectations at 2%.

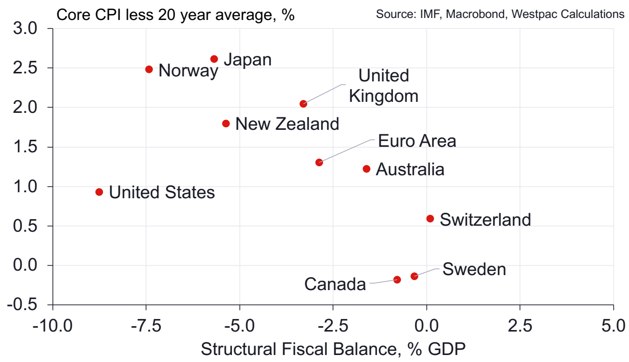
- Inflation measures such as services or non-tradables inflation are falling too slowly. Most of the disinflation so far has been in the tradables sector, where inflation has now normalised and may not move much lower.
- Outside construction, domestic inflation remains very elevated (around 6% yr) and hasn't really eased more than two years after the OCR began rising. Hence gauges of expected costs and pricing intentions remain high. Non-market costs (like rates and utilities) are likely to remain high and will pressure business operating costs.
- Stickiness in core inflation is consistent with embedded inflation expectations and an insufficiently negative output gap with the implication that inflation may bottom out above 2% without further tightening. The balance of risks does not favour relying on a 5.5% OCR.

**Sticky non-tradable inflation implies imbalanced inflation risks**




The legacy of past expansionary fiscal policy is leaving New Zealand with a sticky inflation problem. While fiscal policy will become less expansionary in coming years, the path to a balanced structural fiscal position will be slow requiring tight/tighter monetary policy.

**Structural fiscal balance vs core inflation less 20-year average**

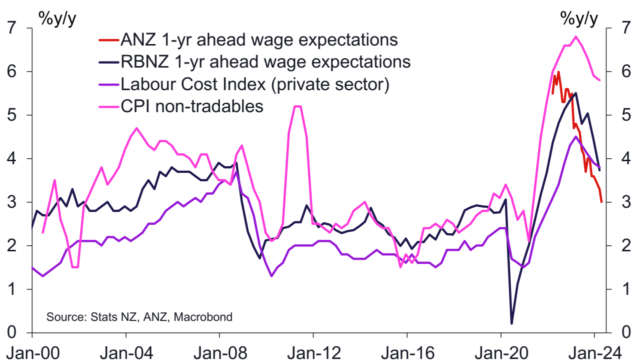



## The Dove's Tale.

Headline inflation continues to fall and will soon be back inside the target range, helping to re-anchor inflation expectations towards the target midpoint.

- Headline inflation will likely fall back inside the RBNZ's target range later this year.
- While most of the disinflation to date has been in the goods sector, lower headline inflation will place further downward pressure on inflation and wage expectations and help to lower services inflation over the coming year.
- Lower headline inflation outcomes will also lower future inflation for goods and services where prices are directly or indirectly indexed to past inflation (e.g. tobacco excise taxes, insurance prices in part adjusting to past construction cost inflation).

**Wages, wage expectations and non-tradables inflation**

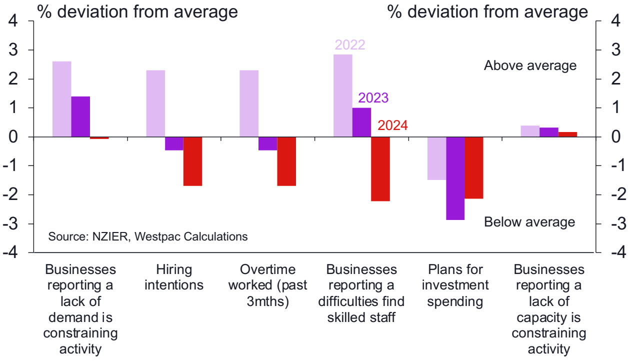



Consistent below-trend growth is beginning to generate surplus capacity in the economy, which will add to downward pressure on inflation.

- Households' spending has turned down, the pressure on their finances is accumulating as average mortgage rates rise and the labour market is softening.
- The related cooling in demand has already pulled down inflation in areas like apparel and durables. The coming year will see increasingly widespread softness in prices.

- Inflation is currently being held up by large increases in areas like local council rates, insurance and energy. While price changes in those areas are less responsive to interest rate hikes, they aren't completely divorced from the state of the economy. The downturn in demand will also make it harder to push through large increases in these areas.

**Capacity and demand measure dropping back**



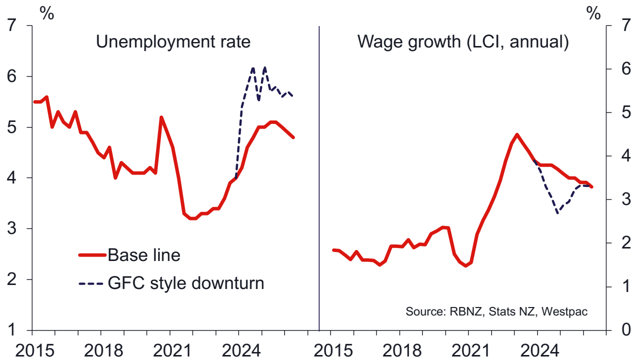

Holding on for too long risks a deeper than necessary downturn in activity.

- Policy changes affect economic conditions with a lag, usually around 12 to 24 months, so the full impact of tightening in policy in recent years has yet to be felt.
- We've already seen that policy tightening is dampening activity and inflation, and there will be a further easing over the coming months.
- Waiting to cut rates risks deeper than required downturns in inflation and the labour market and costly losses of output that may persist for a time due to the 'scarring' that may be associated with business closure and periods of unemployment.
- It could also mean greater volatility over time if larger rate cuts are needed when inflation comes down.

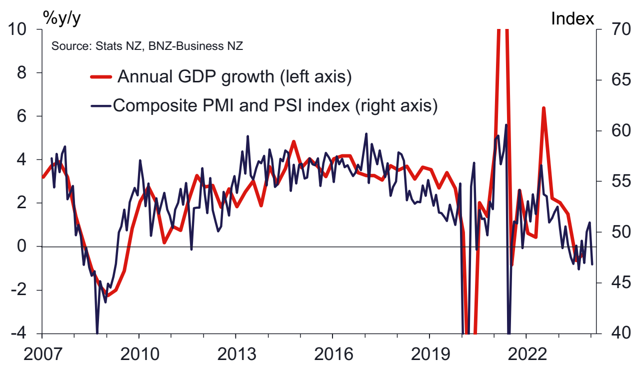
Labour market adjustment is about to come hard and fast.

- A sharp slowdown in labour demand due to the weak economy is about to create a significant mismatch between labour supply and demand.
- The labour supply continues to grow strongly as migration flows adjust with a lag.
- Those conditions herald a significant softening in the labour market. That will see wage growth collapsing, which in turn would push domestic inflation down faster than expected.

**Sudden stop in labour market crashes wages and inflation**




**Real GDP vs composite activity indicator**



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