International Commentary — October 9, 2024

Reserve Bank Of New Zealand Quickens Pace Of Monetary Easing

Summary

- The Reserve Bank of New Zealand (RBNZ), in a widely expected decision, cuts its policy rate by 50 bps to 4.75% at today's announcement. The central bank said growth is subdued and the economy is now in a position of excess capacity, while it also assesses that inflation has returned to the target range.
- By the time of the next RBNZ announcement in late November, several data releases are likely to further confirm the weak growth environment, and well as provide more concrete evidence of a reduction in price pressures. Against this backdrop, we forecast another 50 bps rate cut, which would take the policy rate to 4.25%. Thereafter, we expect a steady series of 25 bps rate cuts in February, April, May and July of next year, bringing the policy rate to a low of 3.25%.
- Overall, we now see the RBNZ easing policy a bit further, and a bit more quickly, than we had previously envisaged. That could also weigh on the New Zealand dollar over time, suggesting downside risk to our medium-term NZD/USD target.

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RBNZ Steps Up Pace Of Monetary Easing

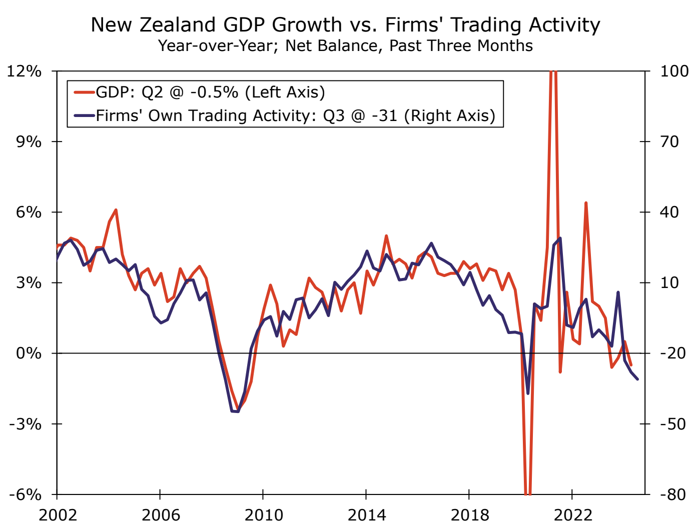
The Reserve Bank of New Zealand (RBNZ) stepped up the pace of its monetary easing at today's announcement, lowering its policy rate by 50 bps to 4.75%, an outcome that was widely expected by market participants. Explaining its decision to lower interest rates aggressively, the RBNZ said:

- Economic activity in New Zealand is subdued, in part due to restrictive monetary policy. The central bank noted weakness in consumer and investment spending, and employment.
- The New Zealand economy is now in a position of excess capacity, encouraging price- and wage-setting to adjust to a low-inflation economy.
- Global economic growth remains below trend.
- It assesses that CPI is currently within the 1% to 3% target range, and indication that its expects Q3 headline inflation to come in below 3%. Moreover, the RBNZ said inflation is converging on the 2% midpoint.

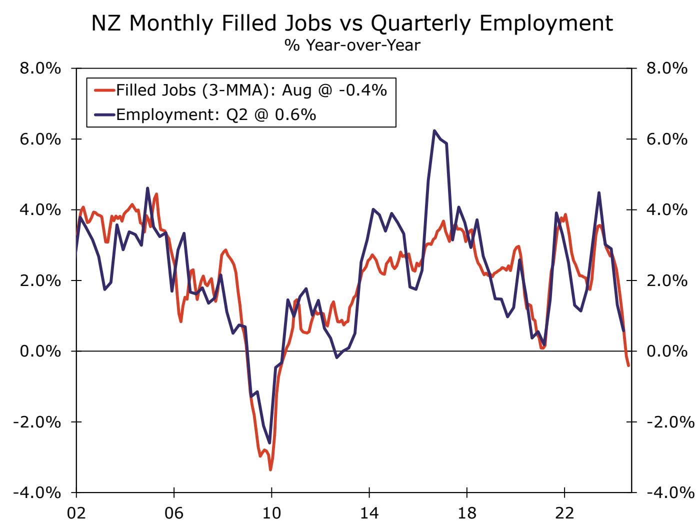
Even with the decision, RBNZ policymakers agreed that a policy rate of 4.75% is still restrictive, which combined with the central bank's economic assessment, offers a clear signal of further rate cuts at upcoming announcements.

New Zealand's Economic Growth Performance Remains In The Doldrums

The RBNZ's decision to deliver a sizable 50 bps rate cut was driven by widespread evidence of continued underwhelming economic performance, subdued trends that the central bank (along with ourselves) expect to contribute to inflationary pressures subsiding further over time. In particular, sentiment surveys remain consistent with subpar economic growth. The Quarterly Survey of Business Opinion (QSBO) showed improving sentiment in Q3, with a net 1% of businesses expecting the economy to get worse, much better than the 44% that expected a deterioration in the Q2 survey. However, a net 31% of firms reported a decline in their own trading activity in Q3, which actually represented a worsening from Q2. This latter point is significant as, historically at least, firms' assessment of their own activity has tended to correlate more closely with GDP growth than overall business confidence.



Source: Bloomberg Finance L.P. and Wells Fargo Economics



Source: Datastream and Wells Fargo Economics

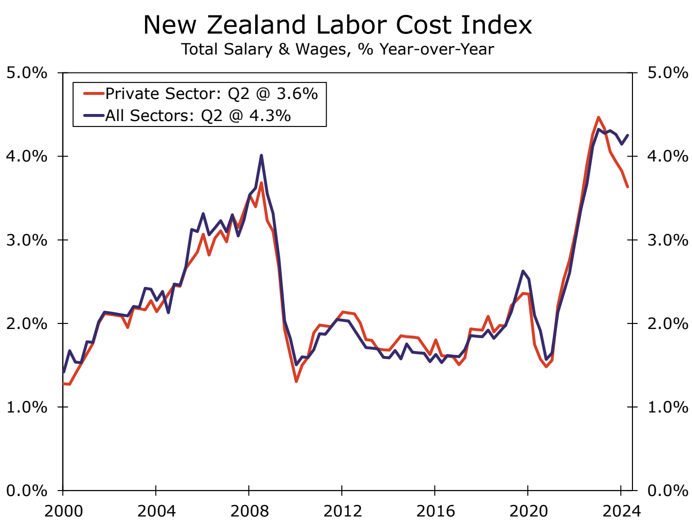
The downbeat message from the quarterly business confidence report also accords with the latest developments in the New Zealand Activity Index published by Statistics New Zealand. The measure is constructed using a combination of high frequency and timely activity figures, along with some sentiment-based data. For August, the activity index fell 0.5% year-over-year, also consistent with a weak GDP reading during Q3. Finally and with respect to the labor market, we observe that monthly filled jobs fell 0.4% year-over-year in August. This measure has historically been a good guide to the more closely followed quarterly employment and unemployment readings, and is consistent with a soft labor market during the third quarter. Altogether, based on the recent range of sentiment data in particular, and activity data to a lesser extent, in our view a sequential decline in both employment growth and GDP growth appear quite likely in Q3. In isolation, trends in economic activity provide a solid case for further rapid cuts from the Reserve Bank of New Zealand.

Inflation Pressures Now Appear To Be Subsiding

While economic growth has underperformed for some time, inflationary pressures have proved stubbornly persistent, which until recently has seen the RBNZ adopt a cautious approach to easing monetary policy. The latest published inflation figures, while now somewhat dated, showed headline inflation at 3.3% year-over-year in Q2, with non-tradeables inflation running much faster at 5.4%.

There are, however, now some early signs that inflation may be decelerating more meaningfully. Wage growth has started to slow, at least beneath the surface, as the labor market has softened. To be sure, the public sector has seen outsized wage increases in recent quarters, meaning that growth in government sector salaries and wages, as measured by the Labor Cost Index, was up 6.9% year-over-year in Q2. As a result, growth in salaries and wages across all sectors has also held up to some extent, at 4.3%. There has however been a clear deceleration in private sector pay in recent quarters, with private sector salaries and wages up 3.6% in Q2-2024, compared to a peak of 4.5% in Q1-2023. Given slower employment growth and rising unemployment, we anticipate wage growth will slow further in the quarters ahead.

The Quarterly Survey of Business Opinion also showed a clearer ebbing of price pressures during the third quarter. Only a net 3% of firms raised prices in Q3, down from a net 23% that raised prices in the second quarter. In addition, only a net 7% of business said that they intend to raise prices in Q4. Outside of COVID, that is the lowest reading since 2015 for that pricing intentions measure, and is also a level historically consistent with CPI inflation slowing to around 1% or below. Evidence of slower wage growth, along with hints of lessening price pressures, ultimately saw the RBNZ opt for a larger 50 bps rate cut at this week's meeting.



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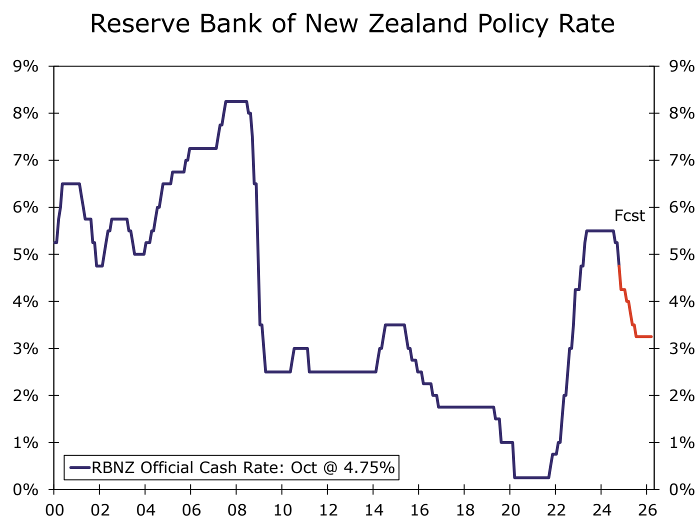

Source: Bloomberg Finance L.P. and Wells Fargo Economics

By the time of RBNZ's next monetary policy announcement on 27 November, several releases are likely to further confirm the weak growth environment, and well as provide more concrete evidence of the reduction in price pressures suggested by recent sentiment surveys. Of particular importance would be confirmation of reduced inflation pressures (including domestic price pressures) from the Q3 Consumer Price Index. The third quarter labor market should be rather soft, and Q3 wage growth will likely slow further. All of this will, we think, provide the RBNZ enough justification to deliver another 50 bps rate cut in November, which would take the policy rate to 4.25%. Thereafter, and as the central bank moves its policy rate somewhat closer to a neutral range, we expect a steady series of 25 bps rate cuts in February, April, May and July of next year, bringing the policy rate to a low of 3.25% by around the middle of 2025. That said, should employment fail to stabilize or sentiment strengthen by early next year, we would not rule out a 50 bps rate cuts at the February 2025 meeting as well. Overall, our outlook now sees us forecast the RBNZ easing policy a bit further, and a bit more quickly, than we had previously envisaged, with the risks tilted toward even faster easing. The contrast between the potential for faster rate cuts from the Reserve Bank of New Zealand, and the potential for slower rate cuts from the Federal Reserve after an initially aggressive 50 bps move, could also see increased downside pressure on the New Zealand dollar. Our formal forecast targets a NZD/USD exchange rate of $0.5700 by the end of next year, though we view the risks around that outlook as very much tilted to the downside.

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