TONY'S VIEW

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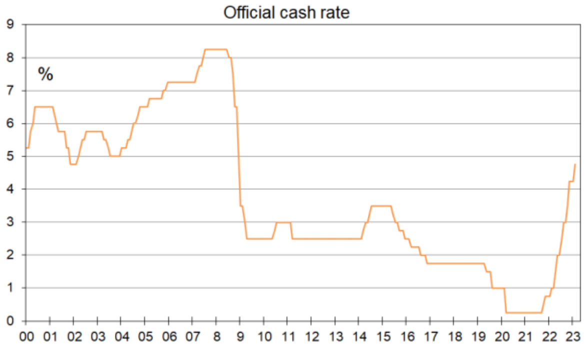
Monetary Policy focus not distracted

The highlight in the world of NZ economics this week was the Reserve Bank's review of monetary policy settings yesterday afternoon and release of updated economic forecasts. There was intense interest in the release for two reasons. First, to see how the Reserve Bank would treat the effects of Cyclone Gabrielle. Second, to see how much weight they would place on some indicators of easing inflationary pressure.

The answer in the first instance is that they expect short-term upward pressure on inflation and downward pressure on economic activity as a result of the cyclone. But with so many uncertainties in play regarding how big and long-lasting these effects will be they are exercising the power granted to them in the Policy Targets Agreement signed with the Finance Minister to look through them – treating them as transitory shocks not requiring a monetary policy response.

That is why the 0.5% increase in the official cash rate exactly matched market expectations which were in place before the cyclone struck. However, the desire to exercise some caution perhaps explains why they have shifted out the timing for when they expect to take the official cash rate to a 5.5% peak from the next rate review on April 5 to by the looks of it the one after that on 23.



This implies perhaps a 0.5% increase in the cash rate again in early-April and a final 0.25% in May. We shall see. There is a very high level of uncertainty regarding how inflationary pressures are tracking and in the United States, United Kingdom, and Australia the latest data on consumer spending have been unusually strong.

It seems that even though consumer sentiment levels and spending intentions are very low, people still want to go out and spend. This will in some cases be done with savings built up during

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the pandemic. But we must acknowledge that we have little insight into how tight labour markets affect people's willingness to spend in the face of a weak economic outlook and rising interest rates.

Hence the need for caution with regard to the pace with which we think interest rates will come down in New Zealand, as discussed here in recent weeks. People should not expect that when rates fall the pace of decline will match that following the 1997/98 Asian Financial Crisis or the 2008-09 Global Financial Crisis. Which takes us to the second point of interest from yesterday's monetary policy review. How much weight is the Reserve Bank giving to some of the signs of inflation turning in the right direction?

The answer is not much. They made their position very clear with many comments explaining their cash rate review. To whit:

"While there are early signs of price pressure easing, core consumer price inflation remains too high, employment is still beyond its maximum sustainable level, and near-term inflation expectations remain elevated."

With regard to the cyclone's impacts, after noting the short-term effects they wrote this.

"In time, the infrastructure and community rebuild will add to activity and inflationary pressures, especially given existing capacity constraints in the economy."

That is, the cyclone will have an overall inflationary impact on the economy because the rebuild will boost demand and we remain short of resources – as many of us have been explaining over the past week. The idea that monetary policy should pause because below 4.0% of the country's population and GDP have been directly affected by the terrible weather does not stand up to scrutiny.

So, what does all this mean for borrowers and savers in New Zealand? Floating mortgage rates and the likes of business overdraft rates will very soon rise by about 0.5% as the cost to banks of funding such variable rate lending is closely related to the level of the Reserve Bank's official cash rate.

Recent upward pressure on bank fixed rate borrowing costs caused by stronger than expected data in the United States is now being locked in. The markets are pulling back from some of their optimism and thoughts about the cash rate peaking at 5.25% rather than 5.5%. And pricing for an easing of monetary policy early next year or even late this year is being pulled back a bit.

This is happening because the Reserve Bank gave essentially no hint that it feels things are remotely close to the point where they can say

"mission accomplished" with regard to the post-pandemic inflation fight. In fact they have raised their forecast for inflation this year from 5.0% to 5.3%, but for 2024 have cut it from 2.6% to 2.4%.

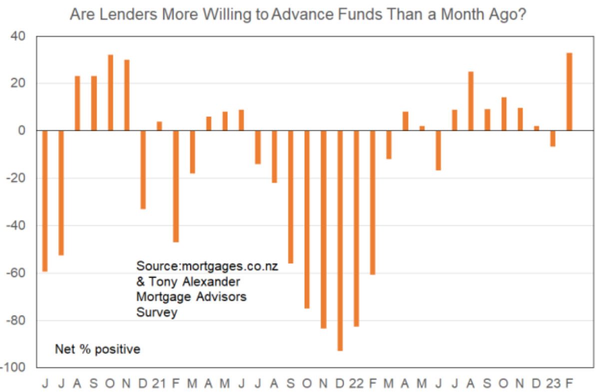
For fixed rate borrowers scope for further cuts in fixed mortgage rates to follow those which have recently occurred are minimal.

However, you may have noticed some discussion in the media yesterday of very special low rates being offered by some banks. As noted here in recent months, banks are not meeting their mortgage sales targets because real estate turnover is falling to levels associated with the GFC. Eager to retain existing customers and acquire new ones as people in other banks seek an alternative to rolling onto a much higher rate with their existing bank, heavily discounted rates are being offered – but not advertised.

One bank is offering a one year fixed mortgage rate of 4.99% fixed for one year with no cashbacks and minimum 20% deposit. Another couple are offering 5.99% fixed for 18-24 months with cashbacks. Another is now taking mortgages where the deposit is only 10% of the valuation rather than 20%.

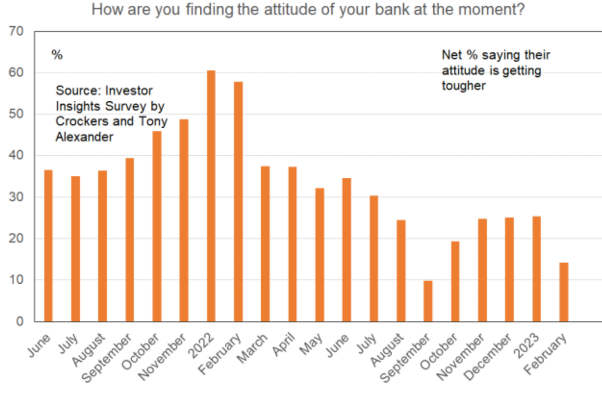
My surveys in recent weeks have shown us that banks have become more willing to extend finance and these insights show some of the ways in which this is happening. Other ways include greater allowance for borrowers to count income from boarders and so on.

This first graph comes from my monthly survey of mortgage advisers and on the far right shows the blip up in the net proportion who feel that banks are becoming more willing to lend.



This second graph comes from my survey of residential property investors undertaken with Crockers Property Management. Along with confirming upward pressure on the pace of growth in recent reported this week by Trademe, it also shows investors' easing difficulties in getting finance from their bank.

The graph measures the degree of difficulty, so decreasing column height means improving credit access.



For investors it might pay to note a comment from the summary of the Reserve Bank's Monetary Policy Committee deliberations.

"It was also noted that deposit rate increases continue to lag the increases in wholesale and mortgage rates resulting in a further widening of bank margins between lending and deposit rates. The Committee expect deposit rates to increase over the coming year incentivising savings, further dampening inflation and supporting the maintenance of current mortgage rates for a longer period."

This is a message to the banks that the Reserve Bank does not feel they are appropriately passing on the full effects of the increasing official cash rate. The primary effect, or transmission mechanism, comes via banks raising interest rates to borrowers so spending gets reduced and businesses lose some of their pricing power.

The secondary effect however is the incentive to save brought about by healthier interest rates being offered to people to save rather than spend their money. That transmission mechanism is not working strongly enough and the Reserve Bank is effectively telling banks to boost their deposit rates.

They probably will. But with so much money sloshing around the financial systems as a result of the Reserve Bank's excessive bond buying activities over 2020-22 the extent of deposit rate rises is likely to be limited. After all, with one bank lending fixed one year at 4.99% and another offering a one year term deposit rate of 5.7%, things do not add up.

The monetary policy review has now been and gone and we now revert to watching the economic data releases to see if we can yet gain some certainty regarding the speed with which inflation is falling and is going to fall away. Going by the continuing string of stronger than expected data being released in the United States and the boost to NZ's pace of growth to come from the weather events, borrowers should curb their enthusiasm regarding how quickly fixed rates fall this year into 2024.

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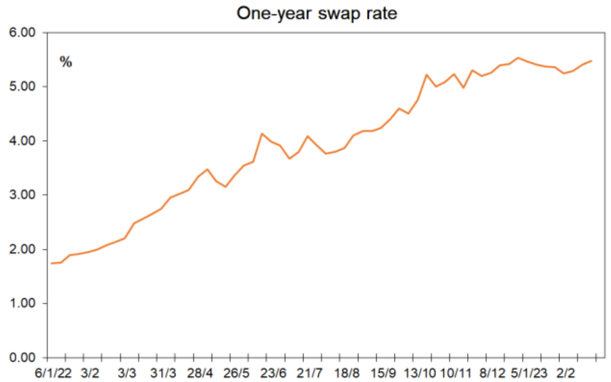
If I were a borrower, what would I do?

I guess I would take the 4.99% one year fixed rate special which one bank is offering. The rate compares with around 6.4% for normal one year rates and will heavily cushion people against the jump from much lower rates they signed up to one and two years ago.

For your guide, in the wholesale markets this week bank borrowing costs have risen in response mainly to higher rates in the United States. Their rates have gone up as a string of economic data suggest that the US economy has greater strength than thought and that means more work will need to be done by monetary policy to get inflation down.

The following graph shows the cost to NZ banks of borrowing money at a fixed rate for one year to lend fixed one year. There are signs of things plateauing out. But it would be unwise to expect falls for a while given the underlying inflation risk hinted at by some developments offshore.



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