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13 February 2025

Antipodean monetary policy

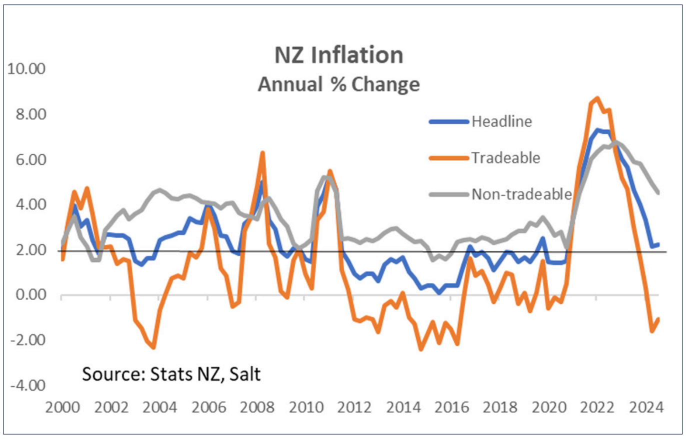
The Reserve Bank of New Zealand (RBNZ) and the Reserve Bank of Australia (RBA) both meet next week. Both central banks are at different stages of their journey. The RBNZ has already eased 125 basis points and is expected to deliver a further 50bp next week. The key interest is what they signal comes after that.

The RBA has yet to ease, stymied by a relentlessly strong labour market and slow progress on disinflation. Market pricing and most economists expected a cautious 25bp cut next week in what will likely be the first of a short, shallow cycle.

For both, the global backdrop has changed significantly since last year. President Trump is safely ensconced in the White House and there is considerable uncertainty about the policy direction in the United States, especially with respect to tariffs. Globally goods and commodity prices are also moving higher. And in a mixture of both US exceptionalism and flight to safety, the USD has been on a tear in recent months, with the NZD and the AUD sharply lower, albeit for different reasons.

Unbalanced to balanced?

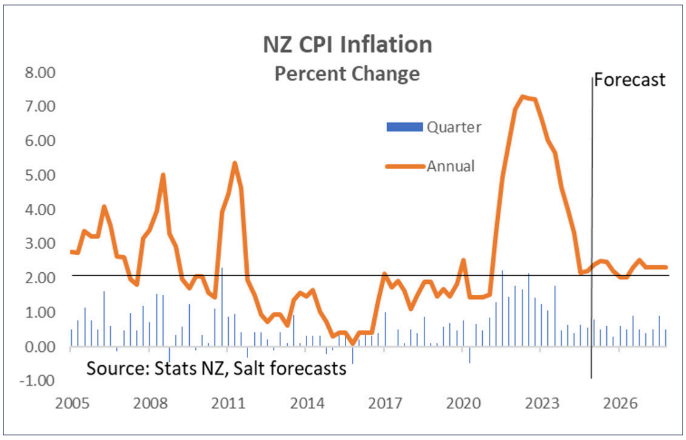
The annual rate of CPI inflation is safely back in the middle of the RBNZ's target range. The disinflation process has, however, been somewhat unbalanced. While the latest annual rate of CPI inflation came in at 2.3% for the year to December 2024, that is the combination of tradable items inflation at -1.1% and non-tradable (domestic) inflation of +4.5%. Core inflation measures are all heading lower and are either within, or in touching distance of, the target band.



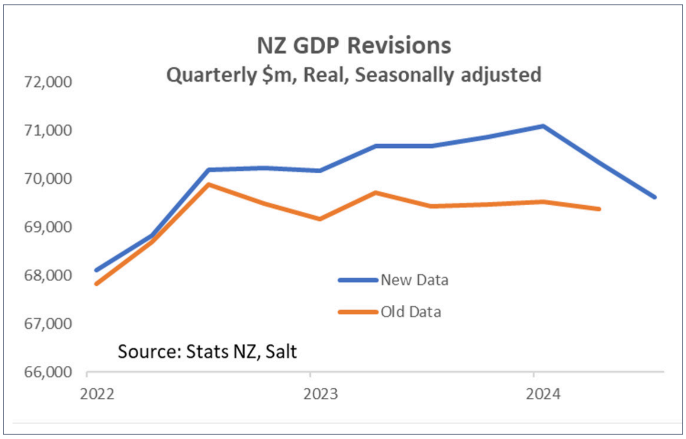
Our inflation forecasts from here look relatively benign, remaining within the target band and close to the midpoint. We expect the RBNZ's will be much the same. There is, however, an important rebalancing dynamic playing out behind the scenes. We expect annual tradeable inflation to rise from here, in part driven by the weaker exchange rate but also the rising trend in global goods prices. The New Zealand dollar has fallen around 6% on a trade weighted basis over the past four months.

Target inflation is thus needing to be maintained by a further moderation in non-tradeable inflation. The ongoing disinflation here is borne of the weak state of the economy and particularly the still-growing spare capacity in the labour market.

An interesting feature on next week's Monetary Policy Statement (MPS) will be how recent revisions to GDP growth have altered the RBNZ's view of the output gap. At the end of last year, Statistics New Zealand released significant revisions to recent GDP outcomes. Those revisions showed growth in the economy had been stronger than previously indicated through 2023 and into early 2024, with sharp contractions in both the June and in the newly released September quarters of last year. The recession had thus come later than previously signalled, and been deeper.



The net result is that the level of GDP was higher in September than the previous data had it in the June quarter. However, it was the sharp downward trajectory of the last two quarters that seemed to confirm the RBNZ would follow through with the 50bp cut in February 2025 that it signalled in its November MPS.



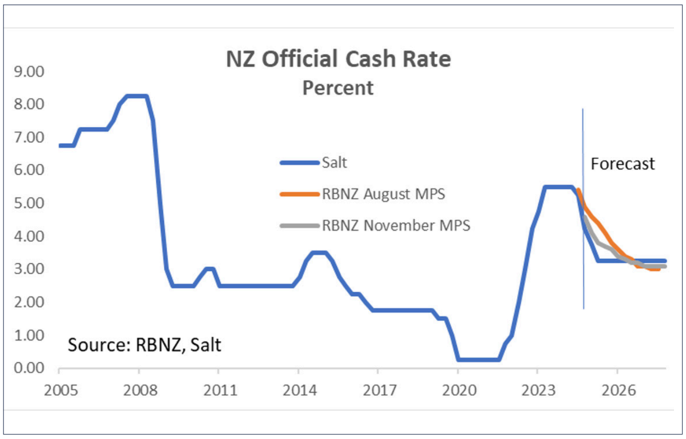
While more recent activity data has been mixed, there has been nothing of significant import to dissuade the RBNZ from its current intended path to cut the OCR to 3.75% next week. That's especially the case with latest labour market data showing a rise in the unemployment rate to 5.1% (which was in line with RBNZ forecasts) and further moderation in wage inflation.

How low will they go?

With a 50bp cut to 3.75% seemingly in the can for next week, the question is what the RBNZ will signal coming after that. We think there will be more caution displayed in the outlook, with 50bp-sized cuts more than likely over.

We have previously argued that while the neutral rate is likely higher than it was been in the recent past, there was scope for the frontloading of cuts. But as the OCR got closer to neutral, more caution would be displayed. The latest estimate of the neutral rate from the RBNZ is that it is somewhere in the range of 2.5% to 3.5%. We think it's likely at the top end of that range, and possibly higher.

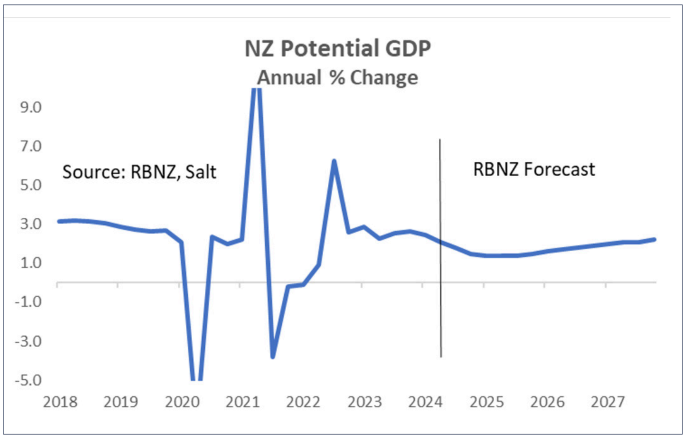
But it's where the RBNZ thinks neutral is that ultimately matters. With a mid-point of 3.0%, we see no reason for the RBNZ to change its projections from November showing a low in the OCR of 3.1%. We are pencilling in two further 25bp cuts in April and May for a cycle low of 3.25%.



Also note that when the Bank eventually stops cutting, expect them to couch this as something akin to a pause for a cup of tea. This may not necessarily mark the end of the cycle, but rather an opportunity for the data to catch up and for the RBNZ to assess whether they have done enough to achieve their objective.

Potential growth matters

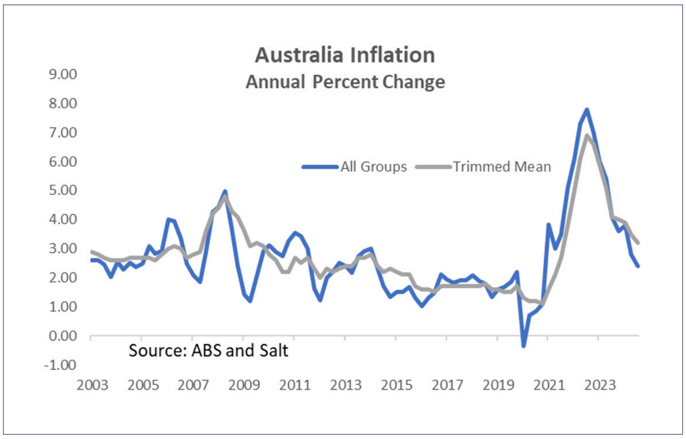
A key reason for caution is the risk of reigniting inflation too soon in an environment of low potential growth. While significant spare capacity has opened recently, once that has been reabsorbed as the economy recovers, we then hit the headwinds of lower growth in the working age population and low productivity growth. While the GDP revisions suggest productivity growth has been stronger through 2022 and 2023, we doubt this will have altered the bank's assessment of our long-term trend productivity growth rate.

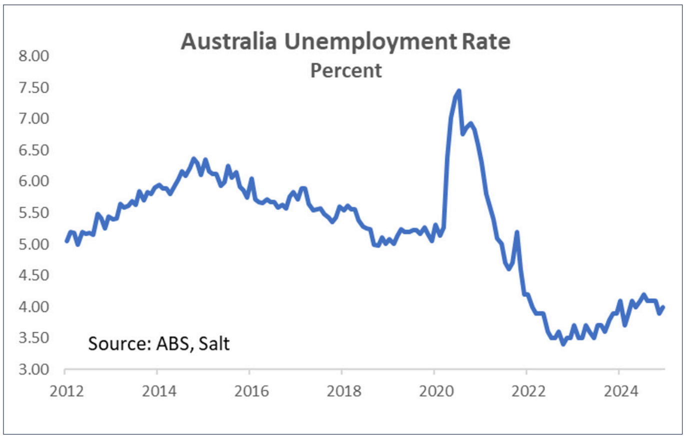


Now or never in Australia?

The RBA did not tighten as aggressively as some central banks, most notably the RBNZ and the US Federal Reserve. That approach carried the key risk that they hadn't tightened enough and might have to start tightening again. Indeed, there were a couple of instances through 2024 when there was some market expectation the RBA would have to do just that on the back of a slow disinflation process and the ongoing tightness in the labour market.

We expect the RBA will cut rates for the first time at its meeting next week, reducing the cash rate by 25bp to 4.1%. That's earlier than our prior expectation of a start in May. The changed timing reflects better progress on inflation relative to the RBA's forecasts, and the dovish tilt expressed in their November statement.





Global uncertainties abound

There are a multitude of global uncertainties in 2025. The biggest immediate uncertainty is tariffs. While there has been lots of tariff noise, exactly where these land and their implications for growth and inflation remains highly uncertain.

More generally there are uncertainties about level of global neutral interest rates in the post-pandemic environment and there are a full raft of global structural factors pointing to higher inflation in the period ahead. These will all have a bearing on the interest rate cycle in both New Zealand and Australia, and monetary policy st

Cautious outlook

The commentary will likely be cautious and highlight a number of lingering upside risks to the inflation outlook including the tightness of the labour market, the recent acceleration in government spending and the unhelpful global backdrop. The Australian dollar is also weaker.

We expect this will be a short, shallow easing cycle with only two or three cuts this year. Any more than that will require a reining in of government spending and/or meaningful weakness in the labour market, specifically a trend increase in the labour market indicating rising spare capacity.