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Antipodean Economic Comment

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Striking RBA-RBNZ divergence and why

Australia/NZ

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- This week brought into stark relief the different approaches being taken by the Antipodean central banks. The RBA decided that after ten consecutive meetings of lifting its cash rate, a sum total of 350bp, it would pause. In contrast, the RBNZ decided to deliver another out-sized 50bp hike, its eleventh consecutive move, bringing the sum of its tightening to 500bp. There are some differences in economic performance, but much of the contrast in approaches is about the central bank's different reaction functions and interpretations of their mandates. Both central banks take risks. Time will tell which proves to be the optimal response.

Lowe, Orr higher. Too cute? Perhaps. As we had expected, the RBA, led by Governor Phil Lowe, decided to pause this week. This is in stark contrast to the RBNZ, led by Governor Adrian Orr, which delivered another outsized hike (a 25bp move was expected, but 50bp was delivered).

However, the differences between the two antipodean economic performances do not seem to be able to fully explain the monetary policy divergences.

Although economic challenges are not identical in Australia and New Zealand, they are certainly similar. Both economies have seen strong recoveries following the re-opening after the pandemic. In both, demand has been pump-primed by earlier massive fiscal and monetary stimulus, while supply has been heavily disrupted by pandemic-related effects, the Russia-Ukraine war and earlier local border closures.

Sharply higher inflation has ensued.

In both economies' inflation appears to have peaked recently, but in both it is well above target. On the latest reads, New Zealand's CPI inflation was 7.2% y-o-y, while Australia's was 6.8% y-o-y (on the monthly indicator). Both economies have tight labour markets but are showing early signs of loosening. Both economies are yet to see the full effect of the substantial tightening that has already been delivered.

Key differences include that wages growth has picked up more quickly in New Zealand than Australia and is already running at excessive rates for the Kiwis. The border re-opening has also delivered a much stronger pick-up in inward migration into Australia, boosting labour supply and housing demand, while in New Zealand the initial impact was outward migration, keeping the jobs market tighter and further weakening housing demand.

Activity indicators, including on consumer spending, are weakening, with New Zealand's weakness more advanced than Australia's, typified by a -0.6% q-o-q fall in Q4 2022 GDP in New Zealand, but 0.5% rise in Australian GDP in that quarter.

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The key point is that it is hard to fully explain the differences in the central bank moves purely on the basis of economic differences.

Likewise, the mandates of the two central banks are a bit different, but, again, not so much so that it fully explains the current contrasting approaches to policy settings. Both have flexible inflation targets to guide their policy settings; both need to aim for maximum employment outcomes.

Much more of the Lowe-Orr divergence seems to reflect differences in the central bank's interpretations of their mandates and differences in their reaction functions.

In short, the RBNZ seems to believe that it needs to bring inflation down more quickly, even if that means delivering a recession. The RBA sees bringing inflation down as important, but is prioritising delivering a 'soft' economic landing and is seemingly more willing to accept that inflation may be above target for longer.

Both central banks take risks with their respective approaches.

For the RBNZ, a key risk is that it pushes the economy into a recession (arguably, this has already begun), but that it also still struggles to get inflation down sufficiently. A recession and high inflation at the same time, is surely the worst of both outcomes. Financial stability risks would be likely to rise in this environment, given that it would likely see further sharp falls housing prices and rising unemployment, which is tough combination given high household debt levels. The recent record current account deficit figures are another concerning factor in this environment, with some risk of balance of payments challenges.

For the RBA, the key risk it takes is that inflation persists at higher than comfortable rates for longer, meaning a longer period of sub-par growth and more sustained elevated interest rates. It could mean an eventual need for an even bigger downturn to get inflation to fall back to target. A patient approach to getting inflation to fall, but the risk being that more economic pain may be needed later or for longer.

These different approaches are captured in our forecasts. New Zealand has a recession, but Australia avoids one. Inflation comes down faster in New Zealand. We see both central banks as unlikely to hike further, but the RBA now has a long pause, while we see the RBNZ cutting its cash rate sooner than other central banks - our central case has RBNZ cuts beginning from Q4 2023.

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