NZ Insight: What would it take to derail OCR hikes?

9 September 2021

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What would it take to derail OCR hikes?

Summary

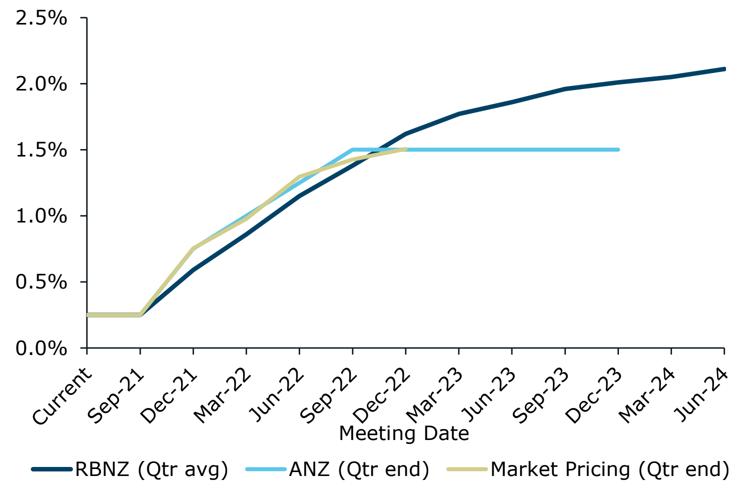
A 25bp OCR hike in October is currently fully priced in by markets, and is our expectation as well. As noted in an earlier insight, we suspect the OCR doesn't need to go as high as 2% to knock inflation on the head. But regardless of the detail, the fact is there's a lot that needs to go right for the RBNZ to complete its hiking cycle, given how late in the piece we're kicking off, and the uncertainties that COVID brings. In this insight, we explore the risks out there that could interrupt this cycle.

- The economy was overheating before the current lockdown. Demand is strong, and COVID has imposed significant supply constraints on the domestic and global economies – driving up prices, wages and inflation expectations. Our central view is that the RBNZ will raise the OCR to a terminal rate of 1.5% by the end of 2022.
- If the RBNZ were to delay hiking the OCR, it would likely be because the latest lockdown had filtered through into significantly and persistently weaker economic confidence and spending, and higher unemployment. These outcomes seem unlikely right now given timely data on sentiment and spending, and encouraging progress on eliminating COVID once more. And even if they did happen, persistent impacts take time to identify, by definition. Therefore, barring some sudden unforecastable lurch, our firm expectation is that the RBNZ will hike the OCR in October.
- Beyond that, there are risks on both sides. However, in our view, risks are skewed towards the OCR not reaching the RBNZ's current projection of around 2% in this cycle (or even changing direction). A number of factors are at play here, including that neutral interest rates are likely to fall further, the supply side of the global economy could recover faster than expected just as demand wanes, reducing inflation pressures, and the unquantifiable risk of an abrupt global risk-aversion event throwing a spanner in the works.
- Given all the information currently available, an October OCR hike remains the most appropriate policy option, in our view. While the RBNZ may end up delaying or even reversing their initial OCR hikes, the catalysts for such a reversal are not clear nor forecastable, whereas the need to better align demand and supply in the economy is pressing.

Introduction

Despite the RBNZ choosing to leave the OCR unchanged at the August meeting (which was the first day of Level 4 lockdown), the dominant thought – and the RBNZ's rhetoric – has very much been that the delayed hiking cycle will commence at the next meeting. Markets have fully priced in a 25bp OCR hike on 6 October (figure 1), and we're forecasting a 25bp OCR hike then too. Markets are right to place a high probability on an October hike, though nothing is ever a done deal 'til it's done, of course.

Figure 1. RBNZ and ANZ forecasts, and market pricing for the OCR



Source: RBNZ, Bloomberg, ICAP, ANZ Research

On the face of it, it is strange that monetary policy tightening is imminent when we're forecasting a roughly 6% fall in GDP in Q3. But, as we noted in our recent Quarterly Economic Outlook, one of the key lessons from the past year has been that COVID is, on balance, a supply shock. Yes, COVID has weighed on economic activity, but it has done this by clogging up the economy and driving up prices. Combine these factors with strong demand, a very tight labour market and rising inflation expectations amongst households and firms, and you actually have the ingredients for a wage-price spiral.

In that environment, the usual policy prescription would be to tighten monetary policy by raising interest rates, and it is indeed our view that OCR hikes are now required, lockdown notwithstanding. But it's important to note that that doesn't mean the overall macroeconomic policy response has ended. Fiscal policy still has a key role to play through lockdowns and well into the recovery, and is actually much better suited than monetary policy to the task. Certainly, fiscal policy also faces the constraint that adding extra demand into a supply-constrained economy is likely to generate more inflation than real activity. But the income shielding of the wage subsidy, for example, is a key part of why we (and the RBNZ) are not expecting the current lockdown to derail economic momentum

However, these are very uncertain times. While the economy did recover rapidly from the lockdown in 2020 (indeed, if anything, too rapidly to be comfortable for the RBNZ), this pandemic has proved very unpredictable, and there's still a lot that can go wrong before we're through this thing. So in this insight we put on our black hats, and ask what factors could cause the RBNZ to call a stop on rate hikes, and potentially even postpone their widely expected October and November OCR hikes.

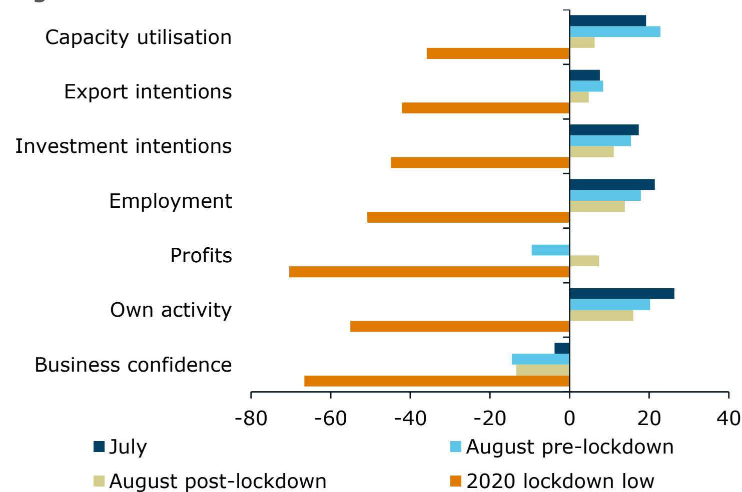
Confidence is key

As noted above, the COVID pandemic has become synonymous with supply chain disruptions, empty store shelves, shortages of raw materials, and skyrocketing distribution costs. At the same time, the efficacy of the fiscal and monetary policy response over 2020 has meant that demand surged as we came out of lockdown, with the severely constrained economy struggling to keep up. All of this means that highly stimulatory monetary policy, which works by boosting aggregate demand, is simply not the right tool for the job of supporting economic growth at the moment.

However, that statement is premised on our baseline assumption that economic confidence isn't dented too much by COVID, and activity rapidly rebounds once Alert Level restrictions are removed. Were business and consumer confidence to suffer a large and sustained deterioration in the wake of the current outbreak, this could feed through into lower consumer spending and business investment. That could be enough to see aggregate demand fall to the extent that firms' biggest problems cease to be disruptions and shortages, and instead become a lack of demand. In this case, further delaying OCR hikes (or cutting the OCR below its current level of 0.25%) could be appropriate to stimulate demand.

Early indications are that business sentiment has held up remarkably well, especially when compared with the 2020 Level 4 lockdown (figure 2). While it's early days, that's really encouraging, since firms may still feel good enough about the outlook to forge ahead with investment and employment plans. We don't have any post-lockdown consumer confidence data, but with the labour market exceptionally tight, households are likely feeling much more secure about their employment and income, and may continue to eat into the savings they accumulated over 2020. And of course, around 60% of the economy is now back at Alert Level 2, solid progress that should shore up confidence going forward.

Figure 2. Business Outlook indicators



Source: ANZ Research

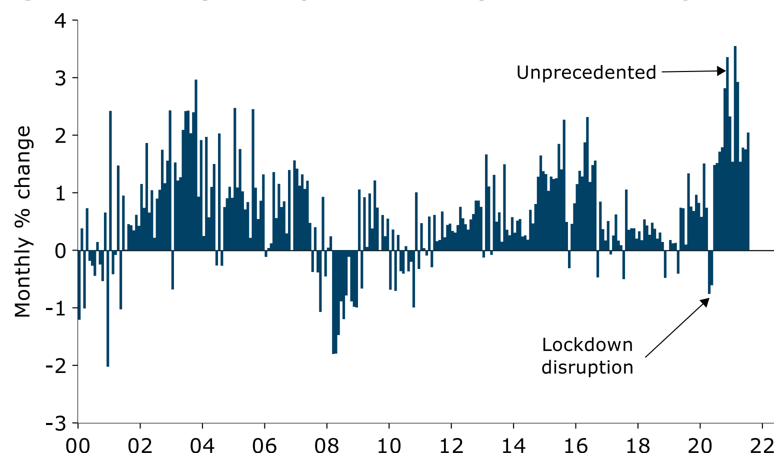
A deep and sustained fall in confidence remains a tail risk that could cause the RBNZ to think twice about hiking interest rates. "Sustained" evidence takes a while to gather, by definition, which is why we are confident that an October hike is a done deal, barring a global sentiment lurch. But beyond that, if Auckland is still in Level 3 or higher into October, then we could see a larger fall in confidence, especially given the region's importance in the national supply chain and domestic tourism. But again, we'd need to see that flow through into persistently weaker demand before easing monetary policy would become appropriate (although the hurdle for a cautious pause is lower). It's certainly possible for confidence to take a sustained dive from here, but it's far from our base case. The next read on business sentiment will be the preliminary Business Outlook results due on 13 September.

What's a bounce without a housing boom?

One of the more significant drivers of economic momentum out of the 2020 lockdown was the surge in housing activity. The stimulus measures put in place in 2020 were designed to help the economy get through what was expected by all punters to be a deflationary demand crisis. But confidence recovered rapidly. Stimulatory monetary policy helped here, but most important was the success of the health response, and the fact we could breathe a sigh of relief and largely get on with our lives. It's fair to say that highly stimulatory monetary policy and easing macroprudential policy was very effective at driving up asset prices, in the context of a national shortage of houses. While this is a key part of the transmission of monetary policy through the economy, it's likely that nobody's plan included a 30% jump in house prices. But while the side effects are truly alarming on many levels, there's no doubt it has boosted confidence and spending, and construction activity also surged, with record levels of new dwelling consents and building activity.

But as we've moved into 2021, the capacity constraints faced by the construction sector have become immense. And while the sector is growing as fast as it can in the face of these constraints, it's clear that housing can't be the main driver of growth going forward. The fundamental supports for higher houses prices have also turned into headwinds, with mortgage rates rising, a tax shock for investors, a huge amount of supply coming online, and lending restrictions now being tightened. That said, house price inflation has remained stubbornly strong so far (figure 3), with an element of FOMO still there as people continued to snap up properties even in lockdown.

Figure 3. Monthly house price inflation (ANZ seasonal adjustment)



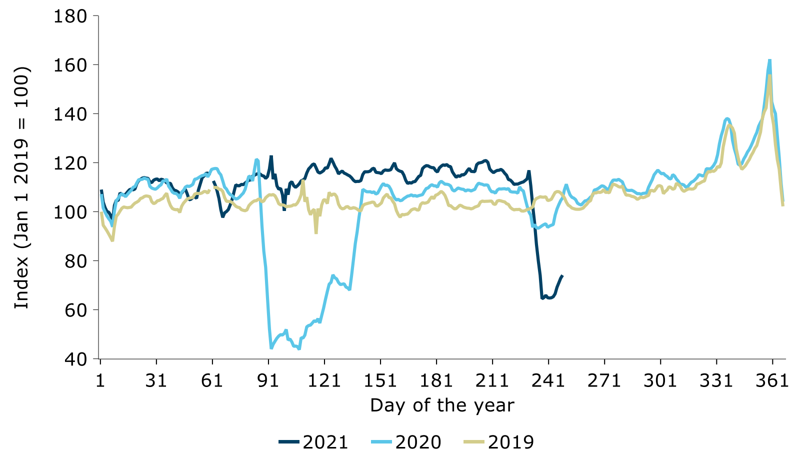
Source: REINZ, Macrobond, ANZ Research

A key uncertainty is whether the economy can rebound as quickly if construction activity is constrained and house prices are no longer rising as quickly. Our current forecast is for house price inflation to slow sharply over the next year, especially as a higher OCR starts to flow through into retail rates (and the RBNZ is picking house price *falls* throughout most of 2023 and 2024). Of course, the wealth gains of previous house price lifts are still present, but the days of your house earning more than you do are numbered.

If it becomes clear that other sectors simply don't have enough momentum to drive the economy forward without ongoing house price lifts, and as a result medium-term inflation pressures ease, then the RBNZ may feel the need to step in and give the economy a further boost with yet lower interest rates, or at least hold off on hikes for now.

This seems a relatively unlikely outcome to us. One of the more encouraging signs from the most recent Q1 GDP data was the breadth of economic momentum. Not only was building activity strong, but so too was household spending and investment – two key ingredients for broad-based economic momentum. Our internal ANZ card spending data shows that domestic demand has been very robust over 2021 (well-above 2019 levels), and while spending did take a large hit as we went into lockdown, it was a smaller drop than in April 2020 (figure 4). It's early days, but spending has already started to bounce back. Some of that might be housing wealth effects, but we suspect more of it is excellent job security, with the labour market the tightest it's been in decades.

Figure 4. ANZ card spending



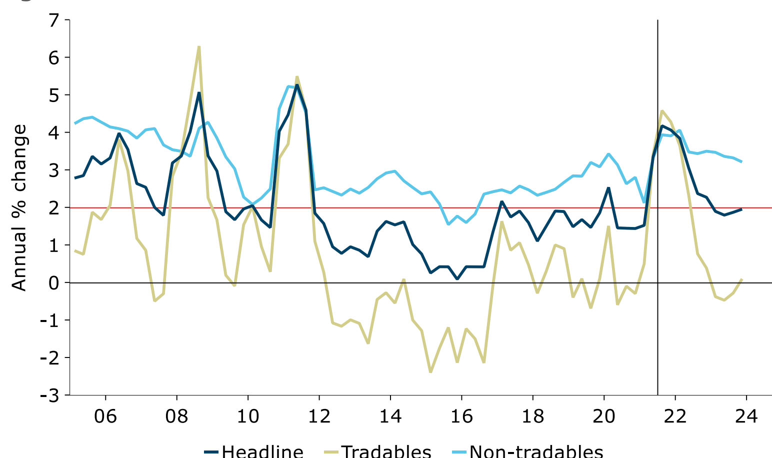
Source: Macrobond, ANZ Research

However, something we can't look past is that for households lucky enough to own a property, that property will most likely be their biggest asset. So if we do see a sustained fall in property values, that could have enough of a confidence impact that some households do reduce spending. Of course, to some extent that is the RBNZ's plan – right now, the economy is running too hot to be sustainable, so the RBNZ wants people to hold back a bit. But it's a delicate balancing act – and if the RBNZ feels that households are being 'too' cautious in the face of a slowing housing market, they may want to take their foot off the brakes for a bit, pausing their hiking cycle.

Labour market in focus

Given our current understanding of how the pandemic affects the economy, the main risk to economic activity is not about demand, but rather capacity constraints that are reducing growth, and driving up prices. The RBNZ is already over-achieving on the inflation side of its dual mandate, and we expect that the current lockdown will do nothing to change that – with inflation expected to peak at just over 4% over the second half of 2021 (figure 5).

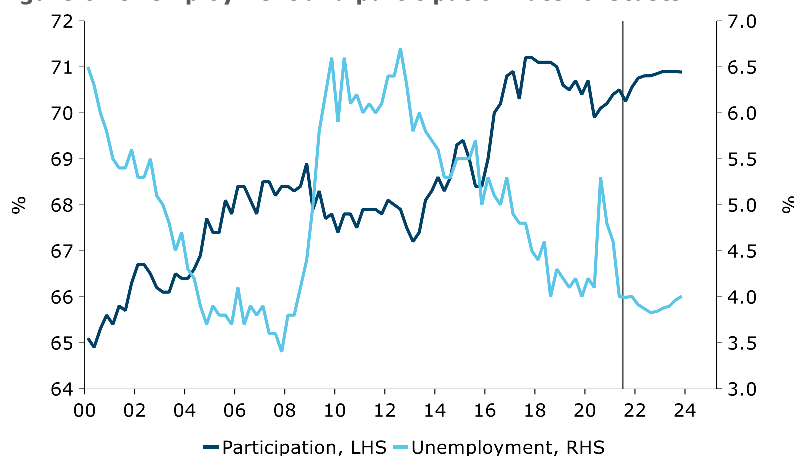
Figure 5. Inflation forecasts



Source: Stats NZ, Macrobond, ANZ Research

It's a little less clear how the labour market side of the RBNZ's mandate will fare as a result of the latest lockdown. Our current assumption is that lockdown won't have a significant impact overall (figure 6), since the border remains closed and labour therefore remains in very short supply. However, there is a possibility that renewed lockdown sees firms (particularly in hospitality) who struggled to make it through 2020 having to close, especially in Auckland where Level 4 restrictions have been in place for longer. That could see more job losses than expected. As things stand now, other firms would snap them up quickly. However, if combined with sagging business and consumer confidence, the labour market may struggle to recover.

Figure 6. Unemployment and participation rate forecasts



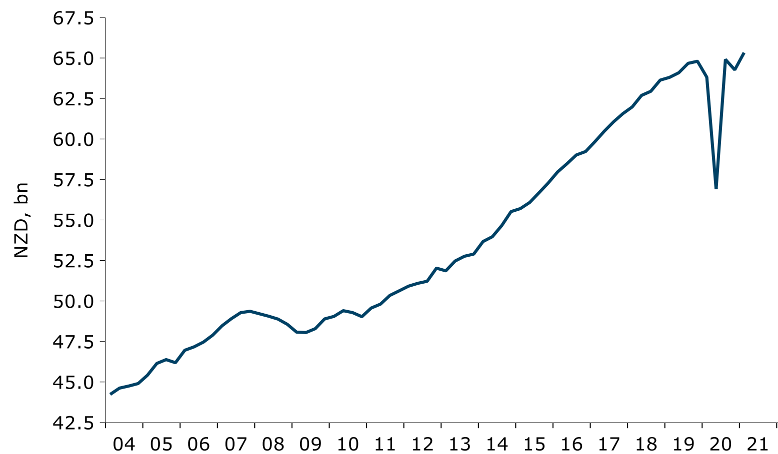
Source: Stats NZ, Macrobond, ANZ Research

It's certainly not our forecast and we think that firms have very strong incentives to hang onto their staff through thick and thin, given how hard workers are to find at the moment. However, if it becomes clear that the labour market is starting to lose momentum, then the RBNZ will potentially face a difficult tradeoff between stabilising inflation and supporting maximum sustainable employment. The RBNZ's monetary policy strategy, as currently articulated, could then see them choose a middle path where inflation is allowed to "overshoot the target mid-point for a time" in order to support employment at its maximum sustainable level. That middle path implies lower interest rates than otherwise (eg via a more gradual hiking cycle).

Uncertainty abounds

A key challenge for the RBNZ will be that they won't get any major data on the state of the economy over Q3 until after the October decision. And even when they do, the data will be noisy. We've seen this with GDP, which has continued to be quite volatile even after the initial lockdown disruption (figure 7). So there is a risk on the face of it that the RBNZ decides to delay their hikes until November so that they have more data on how the economy performed over Q3.

Figure 7. GDP level



Source: Stats NZ, Macrobond, ANZ Research

But it's worth noting here that given the long lag in the production of our GDP statistics, it'll be 2022 by the time we get Q4 GDP data, which will show us the strength of the rebound from Q3's lockdown. So there really won't be much additional benefit from delaying OCR hikes purely for the sake of getting more data, and doing so would only add to the risk of waiting too long for OCR liftoff, requiring more aggressive hikes to keep a lid on rising inflation. Given the sensitivity of our highly-indebted economy to interest rate hikes, aggressive interest rate hikes are probably not ideal.

So while there is a lot of uncertainty and not much data to go on, October seems as good a time as any to hike the OCR. That's not to say that the RBNZ doesn't take uncertainty into account when setting interest rates – it's one reason why we'd consider a 50bp hike in October to be very unlikely (despite market pricing implying a small probably of such a hike).

The RBNZ has previously shown a preference to initiate hiking/cutting cycles at the same time as releasing the MPS since that allows them to articulate the decision. But the market is well primed for liftoff, and if anything it would be a lack of hikes that would need greater explanation, particularly since the RBNZ took every available opportunity after the August MPS to stress that the burden of proof lay squarely on reasons *not* to hike in October – and that lockdown wasn't sufficient. And so far, given that high hurdle, you'd have to conclude we haven't seen any proof that hikes need delaying.

Overall, then, the 'uncertainty' risk here is more pertinent to the follow-up hikes after October. We're picking further hikes at the November, February, May, and August meetings, but there's always the possibility that the RBNZ chooses a more cautious pace of tightening, given the ongoing risk of further COVID outbreaks derailing the recovery.

Up and down?

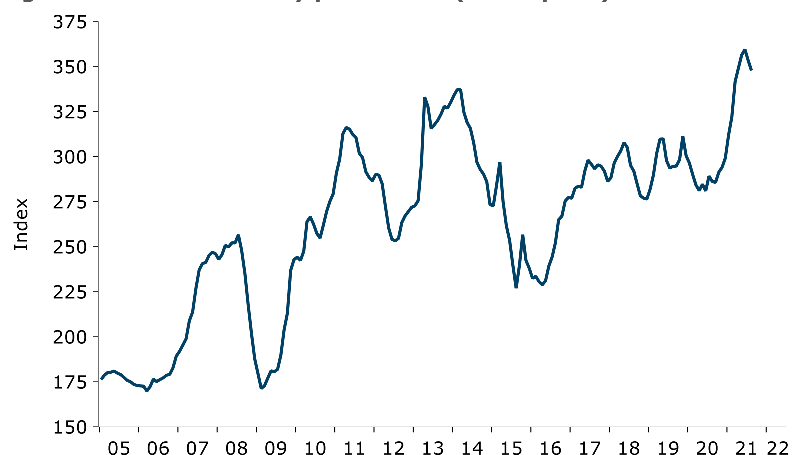
All up, an October hike seems all but done and dusted. If there is a persistent decline in demand in our future, we simply won't know by then, and there's nothing currently in the data to suggest that such a decline is coming. Given the information available right now, an October hike is in our view the right policy option. We think that the bigger risk is that the RBNZ embarks upon their planned hiking cycle, but then is unable to complete it (or even has to reverse it).

There are a few reasons for the balance of risks being skewed downward.

First is our view on the neutral interest rate, a level that's neither supporting nor hindering the economy. The RBNZ thinks that it is currently somewhere around 2%, and they intend to lift the actual OCR to there or thereabouts. However as we explored in a recent insight, long-run global trends are likely to see neutral interest rates continue to grind lower, meaning we only expect the OCR will be lifted to our estimate of neutral, 1.5%, this cycle, even if everything else goes to plan (and that's a big if).

Second, there's a significant risk that the supply side of the economy picks up more strongly over the coming year or two, even as the demand pulse starts to normalise with the sugar rush of super supportive monetary and fiscal support coming to an end. Resolution of supply-side problems would be a really good thing, of course. But that combo of recovering supply just as demand wanes would weigh on underlying inflation. In that scenario the RBNZ may want to hold off on further hikes over 2022 to avoid contributing to fading inflation pressures. This could even be a scenario where the RBNZ is forced to cut interest rates again, especially if they've already started hiking while other central banks haven't (since that may well see a strong appreciation in the New Zealand dollar, weighing on tradables inflation). Recent commodity price movements suggest that the global price pressures we've seen over the past year are peaking (figure 8). If that pressure reverses and becomes a persistent deflationary force, then the RBNZ may struggle to hike in the face of a global tide of lower prices.

Figure 8. ANZ commodity price index (world price)



Source: ANZ, Bloomberg, Macrobond, ANZ Research

Finally, there's always the risk of unforecastable shocks hitting the domestic and global economies.

Ironically, persistently high global inflation could be one path to lower interest rates. If long-term inflation expectations rise as punters start to question whether central banks have the gumption and independence to do what's needed to bring inflation down, long-term interest rates could rise

aggressively as lenders demand compensation for inflation risk. Given astronomical global debt, that could snowball into something quite nasty for asset prices (equities, houses etc) that sees demand fall sharply and persistently. That would see central banks scrambling to shore up demand again as wealth effects turn abruptly negative, hitting confidence. Ultimately, these kind of shocks aren't easily forecastable, and in the absence of clear warning signs, there's not much the RBNZ can do except try to ensure the current economic recovery is on a sustainable path by feathering the brakes (ie raising interest rates).

Even though we think there's a fairly significant risk that the OCR never reaches the levels that the RBNZ is expecting, hiking now still looks like the best option. The economy was clearly overheating before the current lockdown, and so long as we remain on a clear path to eliminating COVID, the underlying situation is unlikely to change. The RBNZ needs to get ahead of the current economic boom to head off a larger-than-necessary bust on the other side – and to do this, they should start hiking the OCR from October, then roll with the punches as they come.

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Last updated: 9 April 2021

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