ANZ Research

NZ OCR Call Change & CPI Forecast Update

19 October 2021

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More work for the OCR to do

Bottom line

- **We have changed our OCR call, adding in 25bp hikes in the April and July Monetary Policy Reviews, in addition to the hikes we were already forecasting at the next four MPSs. This new track sees the OCR reach 2% in August 2022.** While we are upgrading our estimate of how much work the OCR needs to do assuming all goes well, our view continues to be that the risk is high that something will happen to interrupt the hiking cycle before its completion.
- We've also updated our inflation forecasts in the light of yesterday's data, which showed consumer prices were up 4.9% in the year to September (vs. our forecast of 4.5%). As we flagged in our Review, inflation pressures are likely to get worse before they get better, and we now expect inflation will peak at 5.8% y/y in the March quarter of 2022.
- Supply chain disruptions have been a key driver of prices over the past year, and as the Christmas rush builds, these pressures are likely to get worse over the next few months. More concerning for the Reserve Bank is the steep rise in measures of core inflation. It's still highly uncertain how high and when exactly inflation will peak – but it's very clear that more needs to be done to get ahead of the inflation curve.
- We continue to expect that inflation pressures will moderate in time. Supply chains should eventually adjust to the post-COVID norm, and in fact we're forecasting tradable inflation to dip into negative territory as price levels normalise. As the RBNZ removes monetary stimulus from the economy, domestic inflation pressures should also ease.

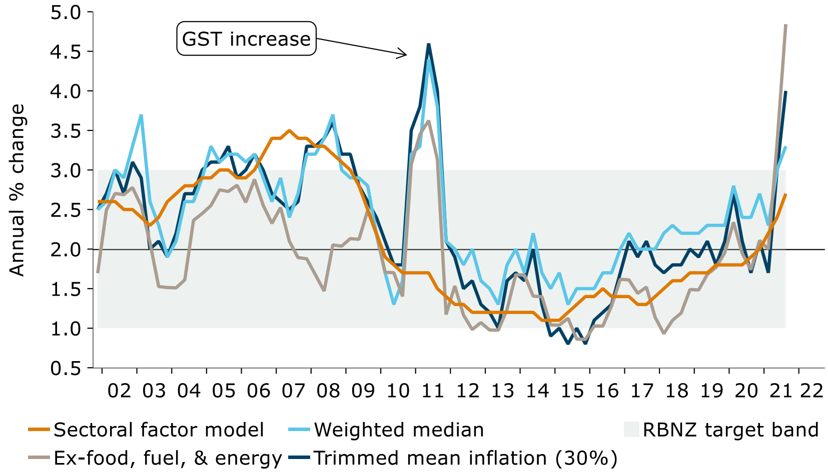
Core inflation is too strong

Consumer prices rose 4.9% y/y in the year to September – stronger than our market-topping expectation of 4.5%, and well ahead of the RBNZ's August forecast of a 4.1% rise. Inflation pressures are everywhere in the economy right now. Petrol prices are surging, supply chains are stretched, food prices have risen six months in a row, labour is in very short supply, and building costs are skyrocketing. Price increases are particularly notable in petrol, food, and housing – essential items that will hit poorer households the hardest.

Of most concern for the Reserve Bank is the fact that there is a very strong inflation impulse underlying all this pressure. Measures of core inflation are the strongest they've been since the 2000s – a period where the RBNZ was persistently behind the inflation curve (figure 1, over).

The Reserve Bank's preferred measure, the sectoral factor model, is the lowest, but at 2.7% and upwardly sloping, one can reasonably question how long that's likely to remain inside the RBNZ's 1-3% target band without action. And the 30% trimmed mean jumped from 3% to 4%, indicating just how broad-based inflation pressures are currently.

Figure 1. Core inflation measures



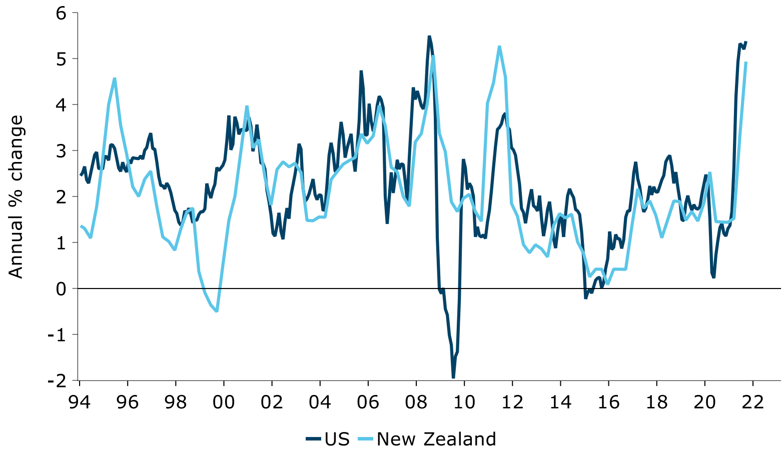
Source: Stats NZ, RBNZ, Macrobond, ANZ Research

Inflation likely to get worse before it gets better

Putting exact numbers to a forecast right now feels like a fool's errand, with the economy going through unprecedented fluctuations. That said, we feel pretty confident in saying that we probably haven't seen the worst of inflation yet.

As we approach summer in New Zealand, not only have we seen oil prices spike on concerns about a global energy shortage; it's also become clear that supply chain pressures are going to get worse in the near term as retailers around the world battle to secure inventory for the holiday season. Newspapers here and overseas are full of stories about businesses wondering if they'll even be able to stock the shelves for Christmas. It's a reminder that for a small open economy like New Zealand, prices are often determined by global factors – something that a quick comparison with US inflation makes very clear (figure 2). And those global factors are still pointing up for inflation.

Figure 2. NZ and US CPI inflation



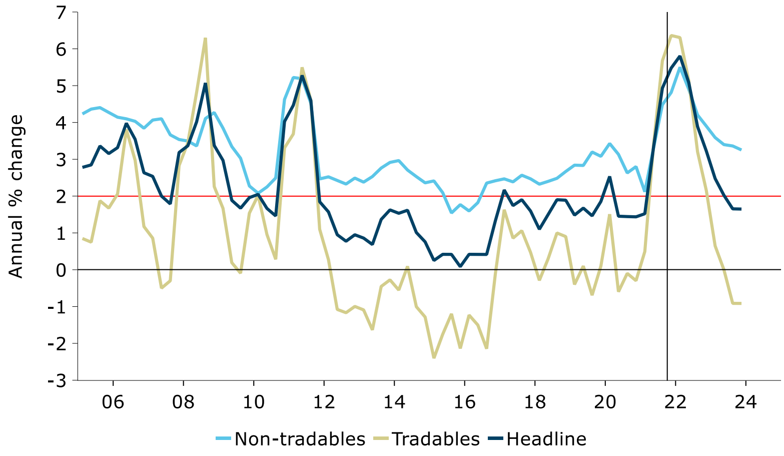
Source: BLS, Stats NZ, Macrobond, ANZ Research

As a result of these supply chain pressures and energy costs, we're forecasting inflation will reach 5.5% y/y in Q4 this year, and peak at 5.8% y/y in Q1 2022 (with a helping hand from the annual increase in tobacco excise tax, which will be indexed to Q3's 4.9% big inflation print). It's impossible to know exactly how much of these supply chain disruptions will flow through into imported inflation – the peak in inflation could be above or below what we've picked. The implications for the RBNZ of tradable inflation surprises would be minimal though, since it's really core inflation that they're worried about.

We continue to expect inflation will slow considerably over the next few years (figure 3). This reflects both the tightening in monetary policy, and a gradual adjustment of global supply chains to the post-COVID normal. Interest rate hikes out to August 2022 should be very effective at dampening the domestic inflation impulse. Many households are highly indebted after taking on massive mortgages during a year where house prices rose over 30%, so even a small increase in interest rates will have a significant impact for those households. That said, recent research by the RBNZ suggests we may not see the peak impact of an OCR hike for at least six months, as households roll off fixed mortgage rates.

The fact that a lot of inflation pressure currently is driven by supply-side factors doesn't mean that raising interest rates won't work to head it off. By reducing appetite to borrow and making indebted households more price sensitive, rate rises still throw sand into the gears of the inflation process by impeding the pass-through of costs. Lower demand means less inflation pressure than otherwise, regardless of the mix of demand and supply developments that kicked it off.

Figure 3. Inflation forecast



Source: Stats NZ, Macrobond, ANZ Research

On the global side, clogged up supply chains have been woefully unprepared for the influx of demand as countries have reopened from COVID restrictions. But at some point this should normalise – both as demand rebalances between goods and services (particularly travel) and as capacity is increased – the latter just takes a while. We assume this happens over 2022/23, leading to a period of falling tradable prices as COVID-related pressure eases.

The timing and magnitude of this is highly uncertain. It's easy to see scenarios where global demand, pumped up by fiscal and monetary support, continues to surge ahead of supply capacity. Alternatively, we may see supply expand just as demand normalises or potentially falls markedly, should global asset prices lurch. Global inflation could easily be either well above or below our forecast. But as long as these movements don't seep into inflation expectations, the RBNZ will likely look through them.

Headline inflation is nearly at the top of the COVID rollercoaster – the big uncertainties are how far we have left to go, and how far and fast inflation will drop on the other side. There's no firm answer to either question. But we do think inflation will get worse over the next few quarters, and will moderate over the next few years. Our current set of assumptions actually imply inflation will be slightly below the RBNZ's target in 2023 (figure 3). But that is just a result of tradables prices falling temporarily as global price pressures normalise. All going well, and looking through these factors, underlying inflation pressures would be expected to be close to 2% by the end of 2023.

Table 1. Inflation forecasts

	Actual		Forecast						
	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23
CPI (% qoq)	1.3	2.2	**1.0**	**1.2**	**0.6**	**1.0**	**0.4**	**0.4**	**0.2**
CPI (% yoy)	3.3	4.9	**5.5**	**5.8**	**5.1**	**3.9**	**3.2**	**2.5**	**2.0**
Non-tradables (% qoq)	1.2	1.8	**1.1**	**1.4**	**0.6**	**1.1**	**0.8**	**1.1**	**0.4**
Non-tradables (% yoy)	3.3	4.5	**4.8**	**5.5**	**4.9**	**4.2**	**3.9**	**3.6**	**3.4**
Tradables (% qoq)	1.7	2.8	**0.8**	**0.8**	**0.6**	**0.9**	**-0.2**	**-0.6**	**-0.1**
Tradables (% yoy)	3.4	5.7	**6.4**	**6.3**	**5.1**	**3.2**	**2.1**	**0.6**	**0.0**

Source: Stats NZ, ANZ Research

OCR needs to do more

Given the intensity of medium-term inflation pressures, we are now forecasting the RBNZ to take every opportunity it gets over the next while to raise the OCR. In short, the very strong inflation pulse has taken away the luxury of time and caution, as the OCR has more work to do. Accordingly, we are adding in OCR hikes at the two Monetary Policy Reviews in the first half of next year, ie in April and July. Along with the hikes we were already forecasting at the November, February and May Monetary Policy Statements, this would take the OCR to 2.0% in August next year.

We estimate the OCR needs to go to around half a percent above neutral, which we estimate to be around 1.5% currently. The RBNZ estimates neutral to be 2%, so we expect the November MPS will show the OCR rising steadily to around 2.5% or a little higher.

It is important to highlight that although we are raising our central OCR forecast, we still think there is a significant risk that something happens to derail the hiking cycle before its completion. Indeed, these risks are intensifying, if anything.

The dramatic increase in wholesale swap rates yesterday was so large there is real pressure for mortgage rates to rise further before long. This increases the chance that housing market momentum could turn more sharply than forecast and flip more abruptly than expected from a support to a drag on household spending and construction activity. And globally, a reassessment of the likely average cost of borrowing over the next few years poses a challenge to asset valuations that underpin household wealth. Thirdly, the longer COVID restrictions in Auckland drag on, the greater the risk of a hit to firms' investment and employment plans – though so far, they've been remarkably robust. All up, it is far from a given that the wheels will stay on the bus while the RBNZ steadily increases the OCR for the best part of a year.

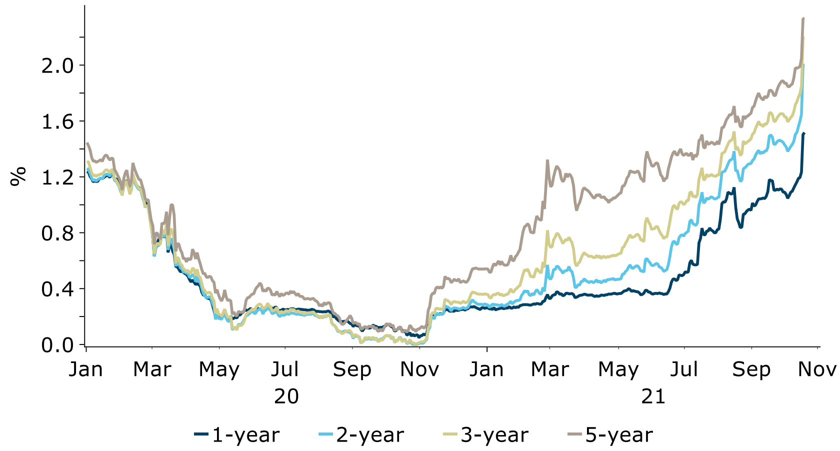
However, given how difficult it is to be definitive about either the timing or magnitude of such potential events, our base case assumption is that things do hold together. And if that is the case, persistent, widespread inflation pressures demand a relatively aggressive monetary policy response in order to keep inflation expectations anchored. The RBNZ can't wait for something to come along to solve their inflation problem, even if they, like us, question the sustainability of some of its current drivers on both the demand and supply side.

Of course, upside inflation risks exist too. Oil prices are rising and could push CPI inflation above 6%. Wage growth could be much stronger than we're anticipating, which would certainly get the Reserve Bank's attention. The inevitable post-lockdown bounce in spending could prove very inflationary in such a supply-constrained retail environment. And inflation expectations could lift further, reinforcing the risk of a wage-price spiral.

The market is, understandably, mulling over the chances of a 50bp hike at the November Monetary Policy Statement. In our view, it's possible, given our fearless Monetary Policy Committee, but unlikely.

- The RBNZ outlined in a recent speech that aggressive moves were suitable only when risks were one-sided and the mandate over the medium term was under serious risk of not being achieved. On the latter point, given our forecast is for CPI inflation to hit 5.8%, one can certainly make a case. But overall, the risks are in no way one-sided. The risks to growth are skewed very much to the downside – not least due to supply disruptions, which are inflationary, but also the risk that the demand picture could abruptly change.
- A 50bp hike would create unnecessary volatility. A similar impact could be achieved with a 25bp hike and an aggressive forward track.
- The market has already delivered a lot of tightening. Swap rates have jumped spectacularly (figure 4), and that will put upward pressure on mortgage rates (and deposit rates). The Funding for Lending program will ameliorate some pressure, but working in the other direction, the gap between banks' deposit and lending growth is currently very wide.

Figure 4. NZ swap rates



Source: Bloomberg, Macrobond, ANZ Research

Market implications

For markets, it's all about what's front and centre – and that's a string of consecutive OCR hikes, and less about the risks – which remain skewed to the downside, for growth at least. Higher mortgage rates and steeper global yield curves are doing some of the tightening for the RBNZ, and markets may struggle to price downside risks in amid an environment of such intense inflation pressures and fears that the RBNZ has some catching up to do.

Short-end interest rates aren't far off pricing in our new forecast, with an OCR of around 1.92% priced in by August, by which time we expect it to have reached 2.00%. However, market pricing is split roughly 50/50 between a +25bp or a +50bp hike next month, with 38bps of hikes priced in for November and another 31bps of hikes priced in for February. In both cases, that's more than we expect. But it's difficult to imagine the market shying away from pricing in some probability of a 50bp hike until November, whereupon the actual delivery of a 25bp hike should settle any lingering fears.

At that point, we'd expect a more consistent profile of hikes to be priced in, but that will do little to take pressure off 1 to 3-year swap rates (and by extension, mortgage rates) if investors and other economists revise up their inflation forecasts for Q4 and Q1, as we have, or inflation expectations keep rising. Markets have a tendency to overshoot, and it's easy to envisage them pricing in an OCR of 2.50% by the end of next year, which is where it would be if the RBNZ hike by 25bps next month, and at all seven meetings in 2022. That speaks to ongoing upward pressure on short-end rates.

FX markets will be less mechanically affected by a higher OCR. At times of high inflation, currency markets have one important question to ask, and that is; has a particular central bank lost inflation credibility? If the answer is yes, then a weaker exchange rate usually follows. But if the answer is no, and credibility remains high, then the cyclical impact of higher interest rates and a more assured long-run inflation outlook typically leads to a stronger exchange rate. We think New Zealand is firmly in the latter camp, and with the RBNZ at the front of the pack in the global monetary tightening phase, all else equal, that speaks to a higher NZD – hence our forecast of moderate strength into year-end.

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