ANZ Research

NZ Insight: RBNZ vs RBA policy divergence

21 July 2021

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Authors

Sharon Zollner
New Zealand Chief Economist
+64 27 664 3554
Sharon.Zollner@anz.com
@sharon_zollner

David Plank
Head of Australian Economics
+61 481 917 043
David.Plank@anz.com
@davidplank12

Contact
research@anz.com

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RBNZ vs RBA policy divergence – inflation persistence key

- Different starting points for inflation and wages go a long way to explaining the different policy stances of the reserve banks of Australia and New Zealand.
- The gap implied by our RBNZ and RBA policy rate forecasts (and market pricing) is certainly not unprecedented in magnitude, but it is very unusual in terms of the timing of the turns of the cycle. It is the policy lag that stands out more than the gap.
- The risks are tilted towards a degree of convergence in the banks' policies: earlier than expected RBA tightening, a stop-start RBNZ tightening or some combination of both.
- The persistence of current inflation pressures will be key. Near-term tests for the outlooks are upcoming wages data in both countries and next week's Q2 CPI in Australia.

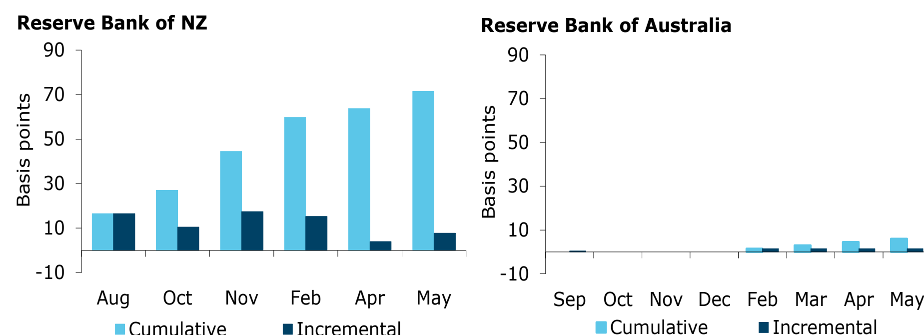
RBNZ and RBA policy to diverge

We are forecasting the RBNZ to lift its Official Cash Rate (OCR) 25bp to 0.50% in August. From there we expect it to tighten steadily until the OCR reaches 1.75% by the end of 2022.

In contrast, we expect the RBA to leave its cash target at 0.1% until the second half of 2023. A couple of rate hikes over that period has the RBA target cash rate at 0.5% by the end of 2023.

Market pricing tells a similar story out to mid-2022.

Figure 1. RBNZ/RBA market pricing: change in cash rate

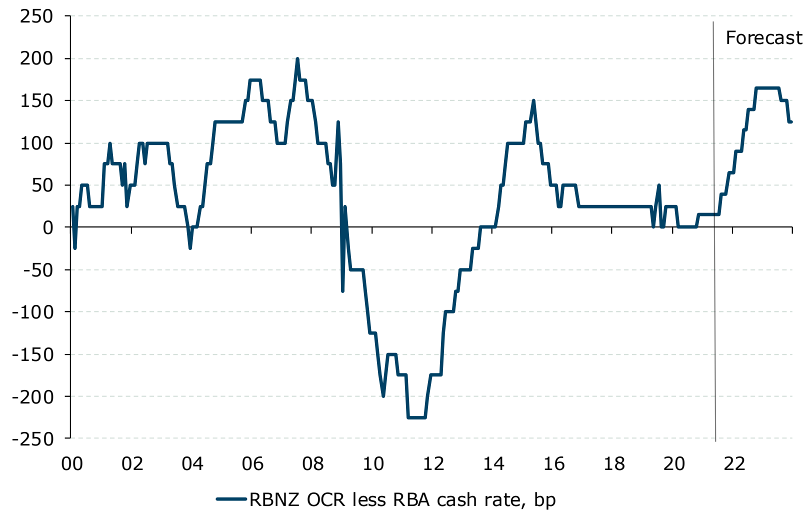


Source: Bloomberg, ANZ Research

Our outlook means that the forecast *gap* between New Zealand's OCR and the RBA's target rate will peak of 165bp in the second half of 2022 (Figure 2). We see it remaining at that level until the RBA starts to move in August 2023.

This gap between the cash rates is not unprecedented. It touched 200bp in July 2007 and averaged 150bp over the course of that year.

Figure 2. RBNZ/RBA policy gap to widen sharply, but not unprecedented



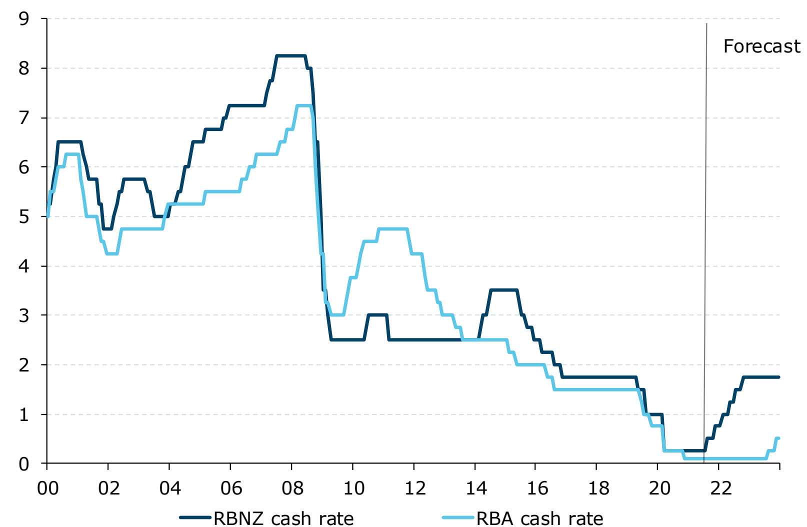
Source: Bloomberg, ANZ Research

Policy lag stands out more than the policy gap

Over the last 20 years there has at times been quite large gaps between the RBNZ's and RBA's cash rates; but there has generally been a close correlation in terms of the direction, with the cycles broadly in sync (Figure 2).

What stands out in our current forecasts is the size of the lag between the RBNZ's and the RBA's first hikes. At 24 months (August 2021 versus August 2023, respectively), the current lag would be the longest since 2000 (noting that the RBNZ only shifted to using a formal cash rate in early 1998).

Figure 3. RBNZ and RBA cash rates: highly correlated



Source: Bloomberg, ANZ Research

Of course, just because the timing gap is expected to be the longest ever doesn't mean the forecasts are wrong.

The RBNZ has started a cycle ahead of a move by the RBA three times since 2000 (ignoring the hike in 2010 that was quickly reversed following the Christchurch earthquake). Of these, only the post tech-wreck/Sep-11 rate hike in early 2002 provided a leading signal on the RBA's next move.

In contrast, the RBA subsequently moved in the *opposite* direction to the RBNZ's moves in 2003 (RBNZ easing, RBA hike) and 2014 (RBNZ hike, RBA cut).

So, early RBNZ moves have not historically provided a particularly useful lead on what the RBA might do next.

In short, every situation is unique, and there are many unusual aspects to the current situation. While both Australia's and New Zealand's economies are facing shipping disruptions, labour shortages and other cost-push factors driving inflation up (as well as strong housing markets), there are also idiosyncratic factors.

It is not out of the question, for instance, that the RBA follows an August rate hike by the RBNZ with a decision to delay the tapering of bond purchases scheduled for September because of Australia's current pandemic lockdowns. Such a decision would represent an easing in policy relative to the RBA's currently intended settings.

This near-term wrinkle in the policy outlook aside, the risks seem weighted toward convergence in the timing and/or the magnitude of the gap. For example, the RBA may well end up tightening earlier than either we or it expects, or the RBNZ may end up with a very stop-start tightening cycle compared to our forecast if the New Zealand economy stutters or the NZD soars.

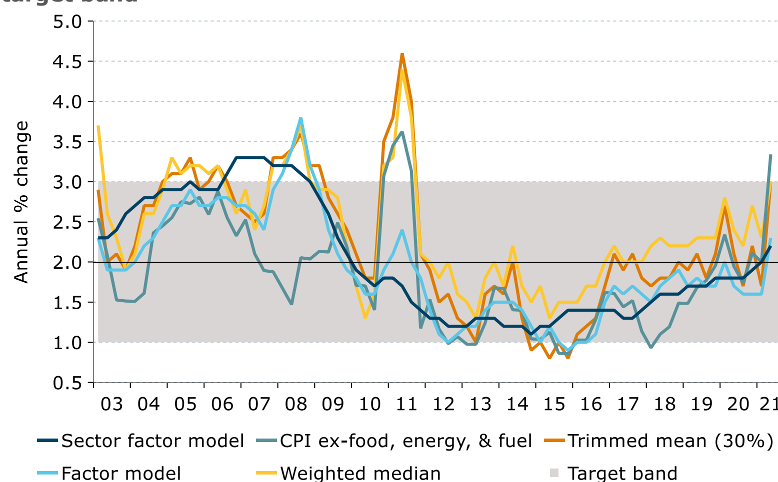
To better understand why the lag exists – not just in our forecasts but also in central bank rhetoric and market pricing – we need to consider the economic circumstances facing each central bank and the framework each is applying to those.

Core inflation already above the RBNZ's target

Consumer Price Index data in New Zealand last week showed the headline figure blasting through the top of the RBNZ's target band, to 3.3%. We are forecasting it to lift to 4.2% y/y in Q3, with non-tradable inflation (the persistent type) in the driver's seat.

The core inflation measures highlighted that the underlying inflation pulse is building. The 30% trimmed mean, which the RBNZ watches, was up 3.0% y/y. Weighted median core inflation measure was up 3.0% y/y. And CPI ex-food, energy and fuel was up 3.3% y/y. The RBNZ's slow-moving sectoral factor model, at 2.2%, is now also above the midpoint of the 1–3% target band and rising.

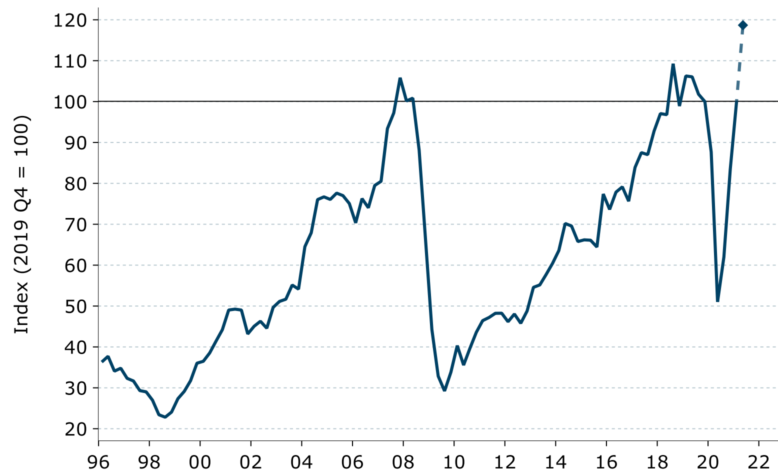
Figure 4. Core inflation by most measures is through the top of the RBNZ's target band



Source: RBNZ, Stats NZ, Macrobond, ANZ Research

Unlike the RBA, the RBNZ tends not to be prescriptive about a required rate of wage growth. While we'll have to wait until 4 August to get updated wage data, recent anecdotes are startling. And for good reason: the labour market is as tight as it has been in decades, as measured by the ratio of job ads to the number of registered unemployed. We expect the unemployment rate fell to 4.5% in the June quarter, but even if it stayed at 4.7%, this tightness indicator would still be at a record high.

Figure 5. Ratio of NZ job ads to the number of unemployed



Source: Stats NZ, MBIE, Macrobond, ANZ Research

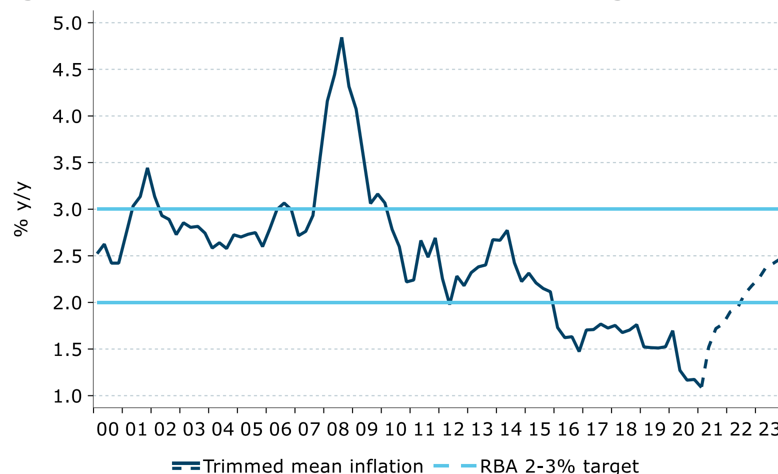
Core inflation below RBA's target, and wages growth too low

As with New Zealand, we are expecting a sharp jump in Australia's annual headline inflation in the June quarter. Indeed, our forecast of 3.8% y/y means headline inflation will be much higher in Australia than in New Zealand. But the story for core inflation looks very different.

After surprising to the low side in Q1, we expect Australia's core inflation to accelerate in Q2; but only to 1.5% y/y – around half the pace of New Zealand. Even with a large positive surprise, it is hard to see core inflation exceeding 2% y/y, which would mean that the long period of below-target inflation will continue (Figure 6).

This fact must be apparent to the RBA, which would explain why it is emphasising that it wants to see inflation sustainably above 2% before lifting the cash rate.

Figure 6. Core inflation hasn't been in the RBA's target band since 2015

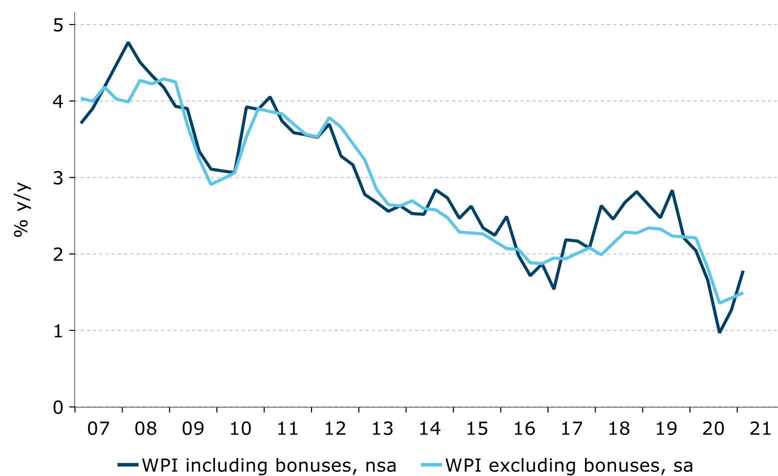


Source: ABS, Bloomberg, Macrobond, ANZ Research

The RBA currently has the period of sub-2% core inflation extending into 2023. We are more optimistic, with core inflation forecast to be above 2% in 2022 and remaining there. Even by the end of 2022, however, we only expect core inflation to be modestly above 2%. We think the RBA will want to see inflation closer to 2.5% before it tightens, to ensure that inflation remains sustainably above 2% in the face of higher interest rates.

The RBA has made wages growth central to its concept of what constitutes sustainable inflation. While Governor Lowe has said that the RBA doesn't have a wages target per se, he has also said that, "for inflation to be sustainably in the 2 to 3 per cent range, it is likely that wage growth will need to exceed 3 per cent." Though wages growth has picked up faster than the RBA expected, it is still a long way short of this level.

Figure 7. Australia's wages growth picking up, but still too low



Source: ABS, Bloomberg, Macrobond, ANZ Research

Our forecasts have wages growth reaching 3% by the end of 2022, but we think the RBA will wait some quarters before reacting to make sure this rate is sustainable and to see what impact the opening of borders might have on wages as the labour market becomes more contestable. Hence our view that the RBA will move the cash rate in the second half of 2023.

This is ahead of the RBA's current forward guidance, which is focused on 2024 as the start date for the increase in the cash rate. This doesn't mean policy will be static until then. The RBA may start tapering its bond purchases in September, though the recent lockdowns of Sydney and Victoria have put that timing in doubt. As well, we expect macroprudential policy to tighten later this year (again subject to the impact of the pandemic). This is an important factor in our expectation that house price growth will slow sharply in 2022.

Different approaches to QE signal data and policy differences

A key signal of the RBNZ's view of the economic and policy outlook is its approach to QE. Last week it announced that QE would end before the end of this month. It is able to do this because its staff was given a mandate to opportunistically reduce purchases as market conditions allowed, and had done so. Purchases had dropped away to negligible levels and were on track to wind up about a month later. There was no clear case that ongoing purchases were necessary for market functioning or to lower bond yields, as confirmed by the fact that the bond market took the news in its stride.

In contrast, the RBA plans to slowly taper its QE program. It will reduce the current AUD5bn per week of bond purchases to AUD4bn, in September. Even this modest reduction is threatened by the resurgence in COVID-19 cases and the lockdowns of Sydney and Victoria. We think a delay to tapering is likely to be discussed at the RBA Board's August meeting, though it is too early to conclude that tapering will be delayed.

Still, the fact the RBA hasn't begun to scale back its bond purchases means a move in the cash rate is some way off. We think it will want to have ended QE before it moves on the cash rate, so it can then assess the impact on the AUD in particular. Of course, if the data were to show a rapid acceleration in wages growth and inflation the RBA could scale back QE and move to cash rate hikes quite quickly.

Policy divergence a challenge but manageable

The different expectations for the two countries' policy rates will cause challenges.

For the RBNZ, the risk of 'going it alone' is that the NZD could head skywards as global investors rejoice in a positive low-risk return on their money. Such a move would feed back into the RBNZ's economic outlook and challenge at least some of the rationale for rate hikes.

For the RBA, the risk is that investors may be more likely to decide it is behind the curve, which could prematurely tighten monetary conditions. We've already seen RBA market expectations on occasion shift in response to hawkish RBNZ rhetoric – a case of the tail wagging the dog. Though at present the surge in COVID cases is dominating pricing in Australia.

However, the RBA can counter any flow-on impact from RBNZ moves with clear communication. Not least by highlighting that a move higher in the AUD in response to NZD strength actually weakens the case for rate hikes, since other things equal it diminishes the likelihood of inflation picking up sustainably.

Risks skewed to policy gap not widening as quickly or much as forecast

With the New Zealand and Australian economies being buffeted by such similar forces, it is natural to ask whether they can both be right. Certainly, the risks do seem to be skewed to the gap not widening as much as we, and the two central banks, currently expect. Who's right is going to depend, like so many things in markets these days, on the persistence of the current inflation shock.

Should it turn out that the inflation shock fades as unsustainable growth drivers dissipate, the RBNZ could find a very stop-start cycle is in store. And of course a large negative shock could see rates cut again.

If the RBA experiences strong upward surprises to core inflation and wages, it will be difficult to argue that the policy rate needs to remain on the floor for so long. Early tests for the respective positions are: upcoming wages data for the RBNZ, and inflation and wages data for the RBA.

Contact us

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Sharon Zollner
Chief Economist

Follow Sharon on Twitter
@sharon_zollner

Telephone: +64 27 664 3554
Email: sharon.zollner@anz.com

General enquiries:
research@anz.com

Follow ANZ Research
@ANZ_Research (global)

David Croy
Senior Strategist

Market developments, interest rates, FX, unconventional monetary policy, liaison with market participants.

Telephone: +64 4 576 1022
Email: david.croy@anz.com

Susan Kilsby
Agricultural Economist

Primary industry developments and outlook, structural change and regulation, liaison with industry.

Telephone: +64 21 633 469
Email: susan.kilsby@anz.com

Liz Kendall (Maternity leave)
Senior Economist

Research co-ordinator, publication strategy, property market analysis, monetary and prudential policy.

Telephone: +64 27 240 9969
Email: elizabeth.kendall@anz.com

Miles Workman
Senior Economist

Macroeconomic forecast co-ordinator, fiscal policy, economic risk assessment and credit developments.

Telephone: +64 21 661 792
Email: miles.workman@anz.com

Finn Robinson
Economist

Macroeconomic forecasting, economic developments, labour market dynamics, inflation and monetary policy.

Telephone: +64 21 629 553
Email: finn.robinson@anz.com

Kyle Uerata
Economic Statistician

Economic statistics, ANZ proprietary data (including ANZ Business Outlook), data capability and infrastructure.

Telephone: +64 21 633 894
Email: kyle.uerata@anz.com

Natalie Denne
PA / Desktop Publisher

Business management, general enquiries, mailing lists, publications, chief economist's diary.

Telephone: +64 21 253 6808
Email: natalie.denne@anz.com

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Last updated: 9 April 2021

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