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RBNZ MPR Review and OCR call change

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Ending LSAP clears the way for an August hike

Key points

- The Reserve Bank today announced that its purchases of assets under the LSAP programme would end by 23 July, in a release titled "Monetary Stimulus Reduced".
- The OCR was left at 0.25% but importantly, the comment that reaching its targets would require "considerable time and patience" was dropped.
- We are now forecasting the OCR to be lifted by 25bp in August, with CPI and labour market data to provide the final evidence the RBNZ requires.

The worm has turned

The RBNZ today decided to reduce monetary stimulus by ceasing purchases under the LSAP but left the commentary about the timing of OCR hikes vague.

There were a few mixed messages, with the RBNZ sticking to some lines about labour market slack and inflation expectations that frankly look pretty outdated, but they acknowledged stronger data and dropped the comment that reaching its targets would require "considerable time and patience", a clear nod towards OCR hikes kicking off than earlier envisaged. The fact that the release was titled "Monetary Stimulus Reduced" is a big flashing sign that the RBNZ considers the monetary policy cycle to have turned.

Growth

The RBNZ acknowledged the better starting point: "Aggregate economic activity is above its pre-COVID-19 level. Household spending and construction activity are at high levels and continue to grow. Business investment is now responding to capacity pressures and labour shortages, and measures of economic confidence continue to improve."

The labour market

The MPC continued to highlight that "reported underutilisation of labour, modest wage growth, and well-anchored inflation expectations" are a source of uncertainty for the wage outlook. And they noted that "without some ongoing monetary support", "medium-term inflation and employment would likely remain below its Remit objectives".

We think that's a pessimistic reading of the labour market and other data we've seen. It's probably a conclusion you could reach based on Q1 data, but recent data has improved in leaps and bounds. As we noted last week, the labour market is probably already at or close to full employment, and this week, June job vacancies data was off the charts. The Policy Assessment did suggest some concern about overshooting on their targets, but we think that that risk is a lot more imminent (on both the inflation and employment side) than the RBNZ appears to think. With CPI and labour data both due before the August MPS, we won't die wondering.

Inflation

Higher headline inflation looms in the near term, but is expected to be temporary. "More persistent consumer price inflation pressure is expected to build over time due to rising domestic capacity pressures and growing labour shortages. However, the Committee noted that uncertainties remain as to the pace and magnitude of any pass-through of costs onto medium-term inflation, especially given reported underutilisation of labour, modest wage growth, and well anchored inflation expectations."

We expect the RBNZ will change its mind on the past three points before the August MPS, as they are simply not consistent with what we are seeing in the ANZBO, QSBO, and job ads. While some price shocks are obviously temporary, when we look at the tightness of the labour market and changes in pricing behaviour there are also some pretty sustainable inflation drivers in amongst the noise. Firms are passing on higher costs, and both business and household inflation expectations have jumped dramatically. That means that the underlying inflation pulse could be a fair bit stronger than the RBNZ has anticipated – we'll get more information come Friday's CPI.

Uncertainty certainly remains. However, in the end, you have to react to what you know, not what you don't. One can always adapt one's approach, but with so much frothiness in the economy at present, the risks associated with inaction now firmly outweigh the risks with taking action, in our view.

Our take

Monetary Policy Reviews don't come with published forecasts, so there was no need for the RBNZ to nail its colours to any particular mast as regards the precise timing of OCR lift-off. Indeed, there are advantages in not doing so – the market will make its own assessment of Friday's CPI data and the labour market data in early August, making any perceived commitment out of date in any case.

There were some mixed messages in the documents, hinting perhaps at some robust debate in the Committee. But the fact that the release was titled "Monetary Stimulus Reduced" underlines that as far as the RBNZ is concerned, the monetary policy cycle has turned. And that implies OCR hikes are imminent, unless something changes in the meantime. Once tightening cycles start they usually keep going.

The softening of this sentence would have been carefully crafted, and sends the same message:

> *"The Committee noted that medium-term inflation and employment would likely remain below its Remit objectives in the absence of* ***some ongoing monetary support."***

Versus the May Monetary Policy Statement:

> *"The Committee noted that medium-term inflation and employment would likely remain below its Remit targets in the absence of* ***prolonged monetary stimulus.****"*

"Some ongoing monetary support" strictly speaking just implies an OCR below neutral. While it's unclear where neutral lies, it's clear a bunch of hikes could be delivered without being inconsistent with that judgement. But we think that judgement will change in any case, as the data rolls in.

The RBNZ has absolutely done enough hand-waving today to tick the 'market-prep' box for an August hike, with CPI and labour market data set to do the rest. The final sentence of the release was a hat-tip to the fact that the balance of risks around the least regrets has flipped – it's all about the risk of shooting out the top: "the Committee agreed that the level of monetary stimulus could now be reduced to minimise the risk of not meeting its mandate." Indeed.

Market reaction

In the lead-up to today's announcement it certainly felt like it was a bit of a coin-toss as to how the market would react. After rapid moves in the last couple of weeks the hurdle for a hawkish surprise was high, but at the same time, the data has more than justified that.

On the day, the Review heading "Monetary Stimulus Reduced" and accompanying guidance that new LSAP purchases will cease by 23 July 2021 was signal enough that the normalisation process has already kicked off – with the logical next step being OCR hikes.

NZD/USD shot up around 50 pips, breaking through the key 0.70 level and testing 0.7020. In response to the LSAP cessation, the NZGB 10-year yield was 7.3bps higher at the time of writing, with similar lifts across the curve. Pricing for an August hike lifted from around 20% priced in to over 50%.

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