ANZ Research

Forecast update and RBNZ Monetary Policy Statement Preview

17 May 2021

Contact

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A whiff of change in the wind

Summary

- ***We are now forecasting the RBNZ to begin raising the OCR in August 2022***, with gradual but steady increases thereafter taking the OCR to 1.25% by the end of 2023.
- In the May Monetary Policy Statement, the RBNZ will again revise up its forecasts for GDP, employment and inflation.
- However, consistent with its "least regrets" approach we expect the RBNZ will continue to signal that removal of policy stimulus remains a long way off. We expect the forecast OCR track (assuming it's published) to suggest perhaps the second half of 2023 for OCR lift-off.
- We do not expect any changes to the LSAP or FLP programmes.
- Markets are likely to seize on any change in language or forecasts in a less-dovish direction.

Resilience

The New Zealand economy is showing impressive resilience. Since the February Monetary Policy Statement, the general flow of data has been more positive than expected. Q4 GDP was nothing flash, but coming off a 14% rise the exact number was always going to be a bit meaningless. And that data feels very old. Since then:

- Surveyed business activity and sentiment indicators have roared upwards. Most activity indicators in the ANZ Business Outlook survey are the strongest since 2017. The PMI and PSI are both very strong.
- Measures of inflation pressure have soared. Reported costs are through the roof and pricing intentions are in uncharted territory, with a net 58% of firms (67% of retailers) reporting they intend to raise their prices.
- Inflation expectations are now marginally above the midpoint of the CPI target band, and rising.
- So far, the housing market appears pretty resilient to the tax policy change recently announced, with sales lower in April but days to sell well below their historical average.
- The unemployment rate dropped to 4.7% in Q1, a level the RBNZ didn't expect to see until 2023, seriously bringing into question the notion that the economy has a good deal of spare capacity. Both employment intentions and job ads have jumped strongly.
- Residential building consents have hit their highest level since 1966 (when the data begins) and construction costs are set to explode higher.
- Firms are reporting worse and worse disruption from freight issues.

All up, the impression is firmly of an economy that is already trying to grow more quickly than it can and suffering inflationary pains doing so, rather than one that needs enormous stimulus, monetary or fiscal, to try to encourage take-up of idle resources.

Downside risks to growth still exist, of course. The domestic vaccination programme is still at an early stage and COVID-19 is still mutating; new housing tax policy and tighter LVR restrictions will dampen investor demand for a long time yet; and the construction sector is really going to struggle to deliver all the consented dwellings (and may get itself into financial trouble trying to do so).

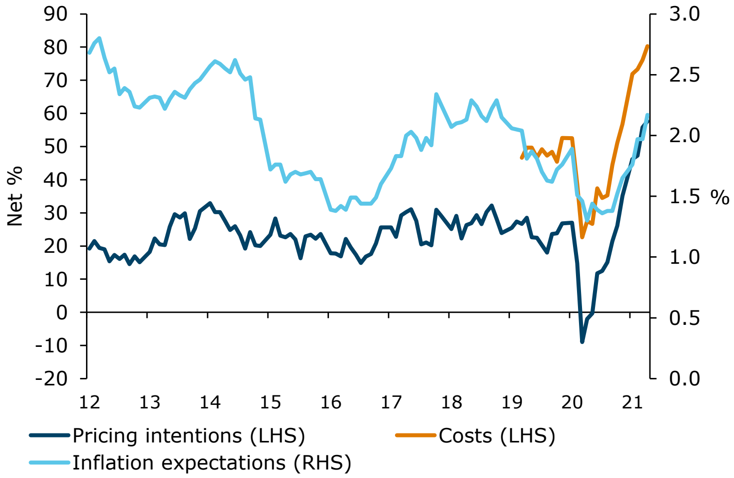
Accordingly, we expect the RBNZ will continue to strike a cautious tone and stress that considerable monetary stimulus remains appropriate and is expected to remain so for quite some time yet while the dust settles and the true economic picture becomes clearer. There's still a lot of uncertainty out there, absolutely. But there is no question that the picture is evolving and that it is getting harder to argue that super-stimulatory monetary policy is the medicine that the economy needs for a prolonged period.

Inflation under every stone

How should one think about the inflation pressure we are seeing at present? It's a global question, not just one for the RBNZ. At face value, it's cost-push and transitory. Global shipping will sort itself out eventually as demand and inventories normalise, and freight rates will fall sharply. High commodity prices will bring about more supply. The minimum wage hike will work its way through, and gradually increasing labour supply as the border inches open will relieve some pressure.

However, inflation pressures are massive and broad-based, as reflected in our ANZ Business Outlook survey (figure 1). Both costs and pricing intentions have accelerated rapidly, with the latter the highest since the data began in 1992.

Figure 1. ANZBO inflation indicators

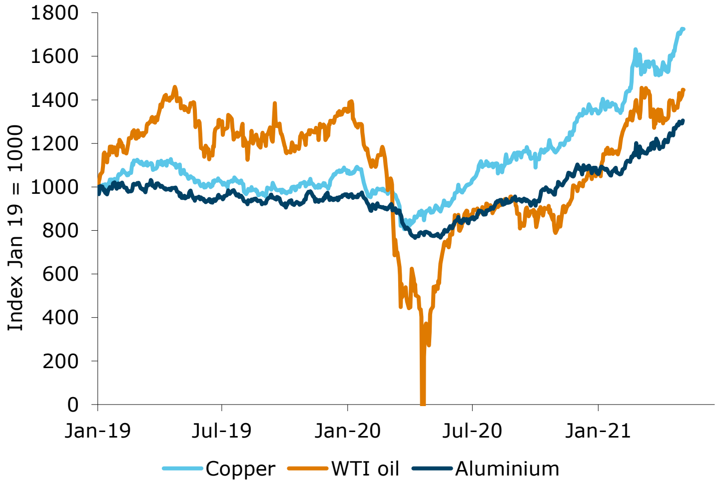


Source: ANZ Research. Note, the final data point (May) is preliminary data.

Price increases are also looking very persistent, and not as simple as just 'cost-push'. Strong demand is a big part of it too, making it easier to pass costs on to recoup margins without fear of customer backlash. Inflation expectations are moving up, and while the RBNZ will certainly welcome the lift to current levels (close to the midpoint of the target band), it's early days.

It’s not just the prices of imported finished goods that are going up either; there’s significant pressure coming along the entire supply chain, as the prices of the most basic products used to make stuff are skyrocketing (figure 2). That’s going to feed through into goods prices for a long time yet.

Figure 2. Selected hard commodity prices

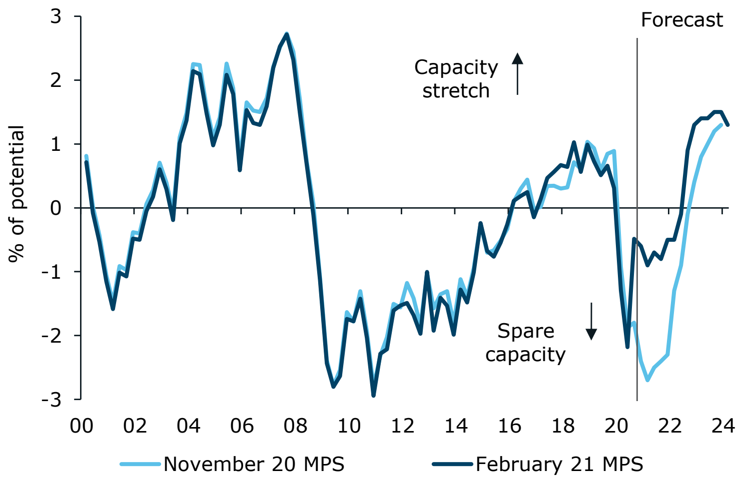


Source: Bloomberg, ANZ Research

And it isn’t just about prices, either; an outright shortage of inputs to production (at any price) means that the supply capacity of the economy is currently severely hampered. And that includes labour. The potential growth rate (the “speed limit”) of the economy is probably quite a bit lower than normal at the moment, though estimating what it might be is exceedingly challenging. The implication, however, is that any given rate of GDP growth will generate more inflation pressure that otherwise in these circumstances.

The RBNZ already massively reduced their estimate of the negative output gap (ie the degree of spare capacity in the economy) in February compared to what they thought in November (figure 3). Certainly, when we travel around the country talking to businesses, this feels like an economy that is currently trying to grow faster than it can; ie an economy that has a positive – inflationary – output gap. That represents medium-term inflation pressure that is harder for the RBNZ to look through than are simple short-term cost pressures.

Figure 3. RBNZ output gap estimates



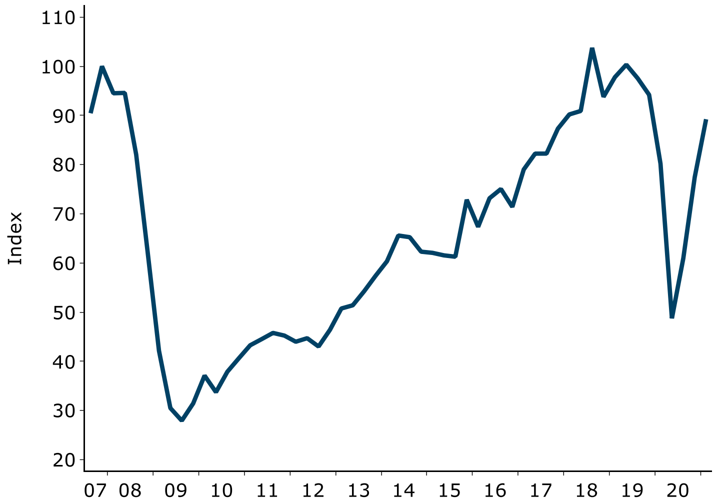
Source: RBNZ, ANZ Research

So why not raise the OCR promptly, then? The hugely complicating factor is that the disruption to the supply of inputs, and therefore to the economy's potential growth rate, is itself temporary. It makes for 'persistent' inflation, yes, but also a significant risk of deflationary pressures emerging down the track, once supply conditions normalise. There's massive uncertainty about when that will be, and what it will look like. And there's no rule book for how monetary policy is supposed to respond to such a situation.

Closely related to this is the question of what "maximum sustainable employment" is currently. There are two key (related) issues hampering labour supply at the moment: the closed border, and skills mismatches. Labour demand is clearly high, as shown by employment intentions, job ads, and employment itself. But firms are reporting that finding skilled labour is their biggest problem. Finding labour is extremely tough across the skills spectrum.

The quarterly labour market data suite showed measures of labour market tightness, such as the job vacancy to unemployment ratio (figure 4), lifting strongly. The one exception was a lift in the labour underutilisation rate, due to more people wanting to work more hours but not being able to for economic reasons. But overall, it's clear that it has become harder and harder for businesses to find the labour they need, and that's a recipe for higher wage inflation, particularly given household inflation expectations are elevated, and also the boost from the minimum wage increase.

Figure 4. Labour market tightness (Job vacancy to unemployment ratio)



Source: MBIE, Stats NZ, Macrobond, ANZ Research

Forecasts

As well as the forecasts for growth and inflation, the market's focus will be firmly on the (standard) OCR forecast.[1] The RBNZ no longer has a reason to not publish such a track – banks are now ready for a negative OCR, and the 12-month unchanged-OCR forward guidance has run out.

We could certainly understand that there might be some reluctance on the part of the RBNZ to resume publishing an OCR track. A completely flat track out multiple years would be stretching credibility, but a whiff of hikes might result in what the RBNZ would deem an overreaction in markets. However, the OCR track is a key part of the RBNZ's projections, and indeed has been

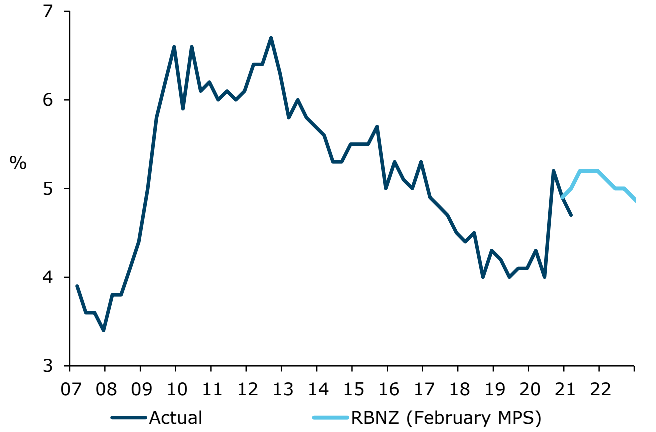
[1] Note this is different to the previously published "unconstrained OCR", which attempts to summarise the stimulus provided by the entire suite of alternative monetary policy tools.

a key source of pride over the years, regarding the transparency of policymaking. The market has not forgotten how to interpret it. It understands that it is a helpfully clear signal of how the RBNZ is seeing the world here and now; it's subject to change just like the rest of the projections, and not a promise or a commitment.

Based on recent data, we expect the RBNZ's updated forecasts will show:

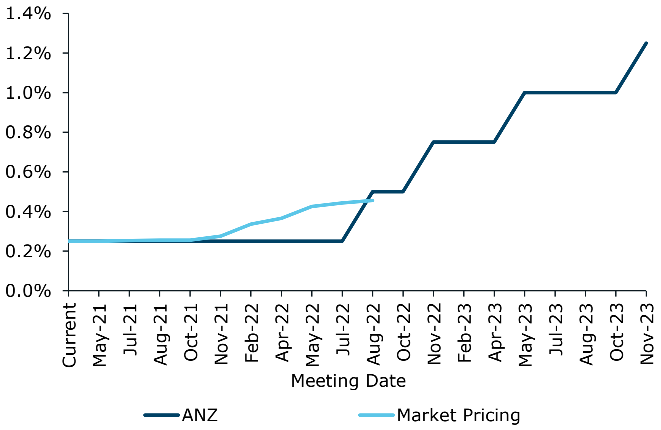
- A lower unemployment rate (amidst considerable discussion about uncertainty surrounding maximum sustainable employment);
- A roughly zero output gap, quite possibly becoming negative again over 2022 as the supply side of the economy is assumed to normalise;
- Higher non-tradable and tradable inflation, particularly in the near term;
- An OCR track that suggests a first hike in the second half of 2023, which would be very mild compared to existing market pricing.

Figure 5. RBNZ (Feb) unemployment forecast & actual



Source: Statistics NZ, RBNZ, ANZ Research

Figure 6. OCR forecast: market (OIS) and ANZ



Source: ANZ Research Bloomberg, ICAP

Bringing forward OCR hikes in our own forecasts

Unlike some global peers, the RBNZ has wisely avoided making any promises that suggest that they will not change their minds when the facts change. Certainly, the RBNZ will want to be assured that inflation is – and will stay – comfortably at or a little above the midpoint of the target range in the medium term, and likewise regarding the maximum sustainable employment goal. But if it is assured of those things somewhat earlier than expected, so be it. We do not doubt the Governor's words that he takes the inflation target very seriously and would act promptly should it appear as if inflation expectations were becoming unanchored from the target. And it's also worth bearing in mind that history suggests we'll get six weeks' notice of a hike, not six months.

Picking an exact date for OCR lift-off is exceptionally challenging at present. As well as the usual forecast uncertainty (at the very least), it is difficult to know how the RBNZ will respond to an unprecedented situation. Capacity constraints are clearly biting hard now, but the economy's speed limit will increase once the border opens wider and supply disruptions ease. When this will occur is highly uncertain, but it may happen precisely as demand weakens as unsustainable growth drivers fade, making for a double whammy.

Our August 2022 start allows time for the situation to become clearer, and for the worst of the supply constraints to work their way through. We think the RBNZ will take a cautious approach consistent with its "least regrets" strategy, waiting longer than normal to hike in the face of clear and present inflation pressures. By August 2022 LSAP purchases are also likely to have concluded (although the rollover of coupons and maturing principal will likely continue for some years beyond that).

At the same time, the RBNZ will not have forgotten the lesson of the 1990s, which was that kicking off a hiking cycle too late makes engineering a soft landing more difficult, and generates what the RBNZ might consider 'unnecessary volatility'. With house prices and household debt where they are, a soft landing is not going to be easy to achieve no matter what, let's be honest, but best endeavours and all that.

While the RBNZ will set policy for what it believes is appropriate for the New Zealand economy, it is reasonable to ask the question whether the RBNZ would be willing to embark on OCR hikes well before the US Federal Reserve or the Reserve Bank of Australia.

In practice, this will depend on a number of factors, including whether the NZD is doing its #1 job of following New Zealand's commodity prices, as opposed to market fashions and whims (it's been impeccably behaved so far). The RBNZ will take the exchange rate at the time into account, along with an estimate of the likely impact should the RBNZ hike out of sync with other central banks. But in the end, if the RBNZ deems that monetary conditions need to be tightened, it's likely not unreasonable for a stronger NZD to be part of that mix.

For now, we've scheduled a very gentle, cautious hiking cycle beyond the initial kick-off, quickly unwinding the COVID-specific cuts but then feeling the way cautiously. There's obviously huge uncertainty when forecasting rate hikes so far ahead, with any forecast track more a stake in the ground regarding the balance of risks than a precisely calibrated firm expectation.

Key messages

The market is in a hawkish mood, and will likely focus on the inevitable upgrade to the economic forecasts – even if the RBNZ dodges explicitly forecasting OCR hikes by cutting short their published track (and regardless of the words the RBNZ uses). But to avoid the market concluding that hikes are imminent, the RBNZ will likely stress that:

- Cost-push pressures are temporary.
- Inflation and employment need to be on track sustainably, and part of being convinced of that is simply runs on the board, which will take time.
- Economic performance is patchy; monetary stimulus is likely to be required for a long time yet.
- The labour market is doing better than feared but still sending mixed messages.
- COVID risks haven't gone away and the border opening is uncertain.
- There are downside risks to both the housing market and global financial markets.

The RBNZ will be aiming for a delicate balance. Stoking expectations of policy normalisation could cause an unwelcome immediate further tightening in financial conditions via both long-end yields and the exchange rate. But not acknowledging the clear evolution of risks won't be seen as credible.

Outlook for the LSAP

We do not expect the Monetary Policy Committee to make any changes to the broad terms of the LSAP (ie its $100bn size and June 2022 end date), but we do expect a gradual slowing in the pace of weekly bond purchases for technical reasons (rather than a change to monetary policy settings).

We expect this to evolve incrementally, with purchases broadly matching bond issuance over the short term, but scaling back gradually over time as government spending (which has lagged issuance over the past year) drives up the level of cash in the banking system. At this stage, we don't expect LSAP purchases to cease before June 2022, but they can slow, especially if banks make more use of the Funding for Lending Programme (FLP), which will have a more direct impact on lending.

Now that the Crown has built up a cash buffer, and as growth recovers, there is less of a need for the RBNZ to suppress bond yields and the slope of the yield curve, and it therefore makes sense for the RBNZ to let the market absorb a similar volume of net issuance that it was absorbing pre-COVID.

We also expect LSAP purchases to continue to tilt towards the short end, giving the RBNZ more optionality in the future (on the basis that purchases can be rolled in future if necessary). Buying a 20-year bond will have an impact, but the impact is singular and the trade leaves a legacy. With the LSAP now more about system liquidity than suppressing bond yields, buying a 2-year bond and rolling it (which is likely to occur, and is indemnified for even beyond June 2022) will give the RBNZ more control over the trajectory of the settlement cash level as the FLP takes on greater importance.

Market considerations

Many in the market, including us, will be looking for consistency in the title of the press release, which read "Monetary stimulus continued" in April. That evolved from "More monetary stimulus provided" in November (when the FLP was introduced), but with the MPS likely to continue to stress that ongoing stimulus is appropriate, we see no reason for April's wording to change. We also expect the RBNZ to highlight up front that there will be no change to any of the Bank's three key policy tools (the OCR, LSAP and FLP). The Summary Record of Meeting should reinforce long-standing phraseology including the Bank's "least regrets" approach, and preparedness to provide additional stimulus if necessary. Any tweak in language in a less-dovish direction will be seized upon enthusiastically.

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