ANZ Research

# RBNZ Monetary Policy Statement Preview

11 August 2021

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Contact

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## Lift off

### Summary


- We expect the RBNZ will raise the Official Cash Rate (OCR) 25bp to 0.50% at the August Monetary Policy Statement next week.
- We would not rule out a 50bp hike along the lines of "while the going's good", but think the RBNZ is likely to go for a more measured approach, with follow-up hikes in October and November.
- The fact that rate hikes may well end up being reversed before long is not a good reason not to raise them now.


### Overheating

The New Zealand economy has moved on rapidly from impressive resilience to outright frothiness. Since the May Monetary Policy Statement, the general flow of data has yet again been more positive than expected. Q1 GDP kicked things off, rising 1.6% in one quarter whereas the RBNZ had been expecting a fall of -0.6%. Since then:

- Surveyed business activity and sentiment indicators are bouncing around the highest levels since 2017.
- Measures of inflation pressure have continued to soar. Reported costs are through the roof and pricing intentions continue to break new ground, with a net 61% of firms (75% of retailers) reporting they intend to raise their prices in the next three months.
- Inflation expectations are now approaching the top of the RBNZ's CPI target band, and still rising.
- CPI inflation is now 3.3%, and we are forecasting it to easily clear 4%. It's not all temporary cost drivers – the broad-based inflation pressure was evident from the fact that the 30% trimmed mean was 3.0% (versus 1.6% in Australia). The RBNZ's slow-moving sectoral factor model of inflation is also now above the target midpoint and rising.
- The housing market has so far been pretty resilient to the tax policy change recently announced. Household house price expectations rose in the last consumer confidence survey.
- The unemployment rate dropped to 4.0% in Q2, a level the RBNZ didn't expect to see over its entire forecast horizon. Both employment intentions and job ads are extremely strong. Labour costs increased 0.9% q/q, a sharp pick-up in what's usually a very slow-moving series.
- Residential building consents are the highest in decades.
- Shipping costs and delays continue to get worse, putting upward price pressure on all imported goods.

Overall, it is clear that the New Zealand economy no longer requires the extreme monetary stimulus a 0.25% OCR provides. Signs of overheating are evident across the board, and the risks of a boom-bust cycle are high and rising. Risks of inflation becoming entrenched are also lifting, with both inflation expectations and wages showing considerable upward momentum.

## Risky business, but you've got to get on with it

A lot could go wrong for the economy. The most obvious sword hanging over our collective heads is the risk of a Delta-variant COVID-19 outbreak, necessitating a return to lockdowns. This will remain a pertinent risk until the nation achieves a far higher vaccination rate. But even if we manage to keep on dodging that bullet, there are real question marks around the global outlook currently, and hence New Zealand's commodity prices and export markets more generally. There's also the very real possibility that without the head-rush of rapidly increasing house prices, the economy may turn out to not have a lot of substance to it at all, given we are actually facing into a negative aggregate income shock – though that fact seems to have been lost in the froth.

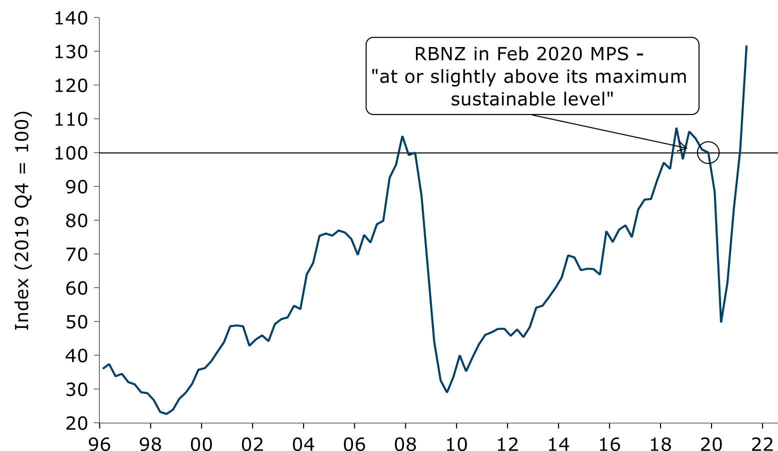
However, the fact that the picture might change abruptly is not a good reason to not respond appropriately to the situation that one faces today. The Reserve Bank can always change direction if required. It's about the balance of risks, and "least regrets", in the RBNZ's terminology. In the last Review, the RBNZ made it clear that they now believe the risks associated with hiking too late outweigh those around hiking too early.

We concur, for a few reasons.

**Firstly, inflation.** A negative shock might well deal a body blow to inflation. But it might not, and that might hamper the RBNZ's ability to ease if trouble strikes.

Why might it not? If inflation is entrenched, it might prove hard to budge. The border is only going to inch open, meaning labour supply will remain artificially constrained for a long time yet. That ups the ante on the risk of a potential wage-price spiral. Figure 1 shows that the labour market is the tightest it's been since at least the mid-1990s, and other indicators are also flashing red.

**Figure 1. Job ads to unemployed persons ratio**

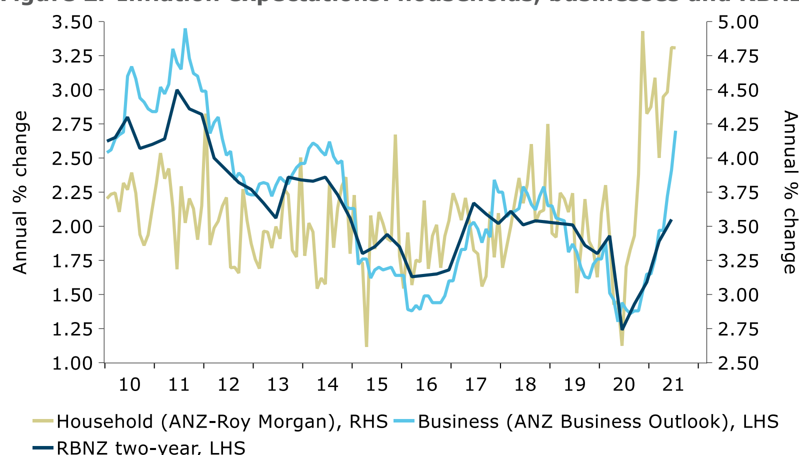



Source: Stats NZ, MBIE, Macrobond, ANZ Research

There are already signs of wage growth picking up. Real wage growth would of course be very welcome. But if wage rises get quickly chewed up by higher living costs, and expectations of more of the same provide more impetus to the next wage negotiation, which means another jump in firms' costs, necessitating more price rises… that kind of self-sustaining spiral makes no one better off, and is best headed off at the pass.

And inflation expectations are rising across the board – the RBNZ gets its own preferred survey measure tomorrow, but our own Business Outlook survey points out the clear direction of travel (figure 2). Inflation expectations can be sticky and something of a self-fulfilling prophecy too, so the RBNZ won't want them to spend too long at high levels.

**Figure 2. Inflation expectations: households, businesses and RBNZ survey**



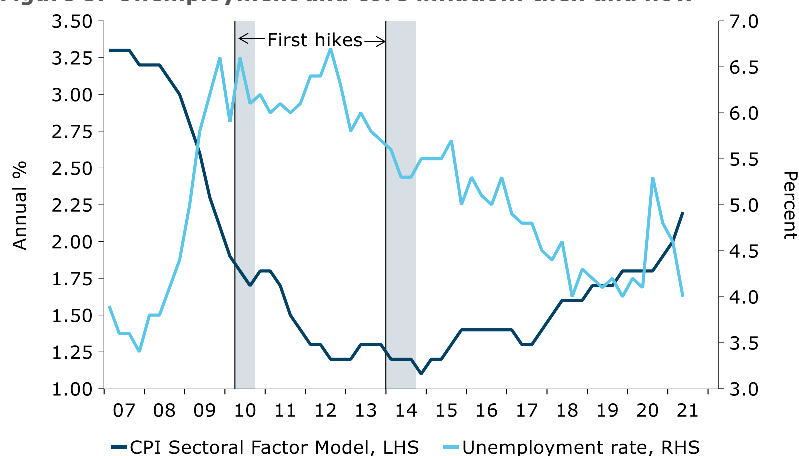

Source: RBNZ, Roy Morgan, Macrobond, ANZ Research

**A second good reason to get on with hikes despite downside risks is avoiding unnecessary volatility in output, interest rates and the exchange rate.** Apart from providing a nominal anchor, inflation targeting is meant to smooth the business cycle. That is, give demand a boost in the bad times but also take the edge off the exuberance in the good times, so that we don't wildly oscillate between these states. Right now, an OCR of 0.25% is persuading people to take on a lot of debt. Even if that has no negative repercussions from a financial stability point of view, the fact is, the 0.25% is currently exacerbating the business cycle – making the current boom bigger, but thereby making the inevitable next slowdown tougher than it needs to be.

In terms of interest rate and exchange rate volatility, the lesson of the 1990s and 2000s cycles was that "a stitch in time saves nine" – that kicking off a hiking cycle too late can lead to a perception that dramatic action is going to be required to rein things in. That can result in the yield curve steepening and the exchange rate rising more than necessary. Of course, with household debt so high and relatively lightly fixed, we don't doubt the RBNZ can get traction on household cashflow quite quickly with rate hikes, but that doesn't mean hiking too late is riskless. Aggressive policy action is more likely to result in a hard landing for the housing market, and if you want to avoid that, then you'd best get on with the job.

Of course, the RBNZ until relatively recently has been more focused on avoiding the policy errors of 2010 and 2014, when premature hikes had to be reversed. But today's situation is very different. Figure 2 shows that both the RBNZ's preferred measure of core inflation and the unemployment rate are much more clearly pointing towards hikes being appropriate than they were back then. Back then the RBNZ hiked in anticipation of a tight labour market and inflation. Today, it's here in the red-hot data.

**Figure 3. Unemployment and core inflation: then and now**




Source: RBNZ, Stats NZ, Macrobond, ANZ Research

## 0, 25 or 50?

This is a challenging meeting for financial markets, insofar as 0, 25 or 50bps are all possible outcomes, and could be justified without a blush. We'd put 10% odds on no hike, 65% on 25bps, and 25% on 50bps.

In terms of why we think they will hike: the last Review was entitled "Monetary stimulus reduced", signalling a clear start to a tightening cycle, and the data has been one-way since then.

As regards 50bp, we'd certainly never say never. There are precedents for this committee along the lines of "just do it." But this is the first hike of the cycle, in a highly uncertain environment where the world could change any second and flexibility is therefore valuable. The RBNZ is also going it alone and will therefore have a wary eye on the exchange rate, and finally, the October meeting is only six weeks away. But all the reasons we gave above for needing to get on with raising the OCR are also reasons to move fast. So the market is correct in our view to put some odds on an outsized move.

## Forecasts

The forecasts for growth and inflation will clearly be revised up. But the market's focus will be firmly on the OCR track. The RBNZ demonstrated in May that they weren't afraid to show a track that engenders a market reaction, so the track should be interpreted as their true 'best guess' – subject, of course, to change if things don't go to plan.

Given higher inflation, growth and employment inputs, the raw model run will scream that the OCR needs to very quickly go much higher, especially if the RBNZ raises their output gap estimate in-line with what our indicators are showing us. But the model doesn't know about COVID or the closed border, and lots of judgement will need to be applied to account for the fact that the world is anything but normal. With the RBNZ set to 'go it alone', while other central banks are on hold, interest rate differentials are likely to widen abruptly between New Zealand and the rest of the world. All else equal, that will weigh significantly on the model-generated OCR track via a higher exchange rate.

In May, the RBNZ showed hikes kicking off a year from now, reaching 1.75% in steady steps. Our base case is that we essentially see this track brought forward 12 months. One tail risk is if the RBNZ has updated their thinking and modelling on the neutral OCR. In the May Monetary Policy Statement, the average of the RBNZ's neutral models was down to 1.9%, and we suspect it's now closer to 1.5% than the 1.75% that the OCR reached in their last forecast.

That risk aside, we could see the RBNZ lower the endpoint due to their intention to tighten macroprudential restrictions. But insofar as that announcement was in response to higher-risk mortgage lending holding up better than they had anticipated, that argument would be a bit circular.

The market is likely to focus most closely on the forecasts out to the end of this year, and in particular, whether an October follow-up hike is anticipated. Beyond that, anything could happen. That's the world we find ourselves living in.

# Contact us

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We welcome your questions and feedback. Click here for more information about our team.

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