ANZ Research

RBNZ Monetary Policy Statement Preview

17 November 2021

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Contact

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Take a(nother) hike

Summary

- We expect the RBNZ will raise the Official Cash Rate (OCR) 25bp to 0.75% at the November Monetary Policy Statement (MPS) next Wednesday.
- Given recent upside surprises to both inflation and employment we would not rule out a 50bp hike. But the RBNZ can achieve a similar tightening in financial conditions with lower risk via a significantly higher OCR endpoint forecast.

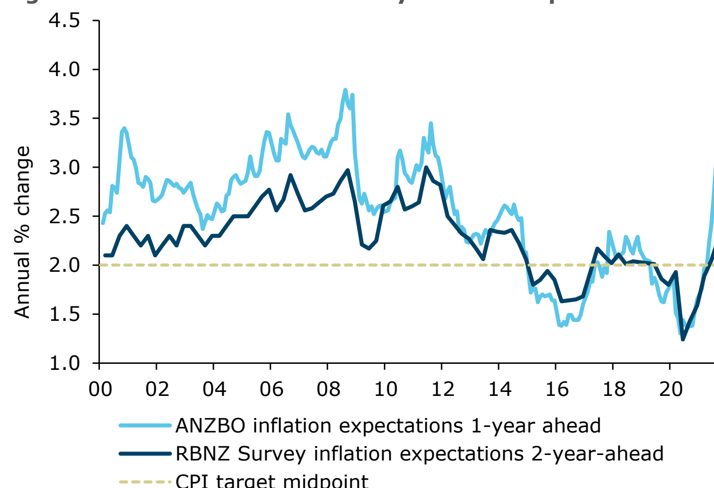
Need for speed?

It's certainly interesting times for the New Zealand economy. The labour market is the tightest it's ever been and inflation pressures are intense, but on the other hand the housing market cycle is looking very mature, and there's the small matter of COVID spreading its way around the country.

On balance, the case for tighter monetary conditions is clear. It was already clear months ago, and the August MPS laid out an OCR forecast going just north of 2% by the end of the forecasts, with a first 25bp hike duly delivered on 6 October at the Monetary Policy Review, once the lockdown dust had settled. Since then,

- CPI inflation came in at 4.9% versus market expectations of 4.2% and the somewhat dated MPS forecast of 4.1%. The increase was broad-based, with non-tradable and core measures substantially beating expectations as well. We're now forecasting a peak of around 6% in Q1, and the RBNZ will be revising up their CPI forecasts substantially too.
- Consistent with that, 1-year-ahead business inflation expectations have jumped to 4.3%; household 1-year-ahead inflation expectations have jumped to 6.2%, and the RBNZ's preferred measure of 2-year-ahead expectations out on Thursday is no doubt going to leap as well, the only question being how high (figure 1). Firms' reported costs and pricing intentions also remain extremely strong.

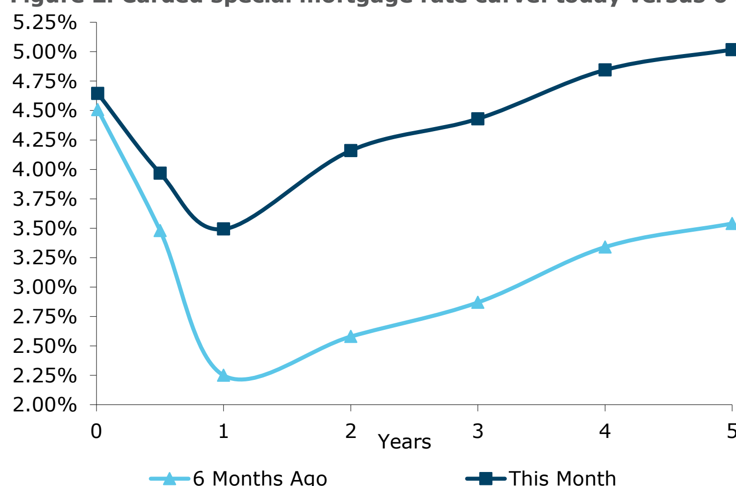
Figure 1. ANZBO and RBNZ Survey inflation expectations



Source: RBNZ, ANZ Research

- The unemployment rate for Q3 came in at a record-low 3.4% despite record-high labour force participation. It was an absolute ripper, confirming incredibly strong labour demand and an exceptionally tight labour market. As COVID spreads, the labour force participation rate may drop – that's been the international experience. And while it will soon be easier to import labour, we may lose more workers to Australia as well. In short, the RBNZ won't be able to forecast with any confidence that labour market tightness is set to ease any time soon. Their wage growth forecast is likely to be revised up substantially.
- ANZBO business activity and sentiment indicators have eased, but the levels are still very respectable. Hiring intentions are particularly robust.
- Supply-side disruptions and cost escalation continue to plague a range of industries, with construction most severely affected, though there are tentative signs of reaching some kind of peak.
- The housing market has turned, albeit only slowly. Seasonally adjusted sales are well off their peak, but annual house inflation only just so. The RBNZ continues to consult on debt-to-income restrictions to further rein in higher-risk lending.
- Swap rates have soared as markets have reassessed where the OCR is likely to sit over coming months and years, and mortgage rates have naturally followed suit. Indeed, we've seen the fastest increase in mortgage rates in at least 15 years (figure 2). A lot more effective tightening has been delivered than just one standalone 25bp OCR hike. Given the risks of a harder landing in the housing market than it might aim for are real, it's not clear that the RBNZ would necessarily want to engender another widespread round of mortgage rate hikes, as opposed to just locking in what's there now.

Figure 2. Carded special mortgage rate curve: today versus 6 months ago



Source: interest.co.nz, ANZ Research

Weighing up that list, it's clear that there is urgency to tighten monetary conditions, and a good deal more urgency than was evident at the October Monetary Policy Review. We expect the endpoint for the RBNZ's OCR forecast to be revised up substantially, perhaps as high as 3%, even though it is our forecast that by the time the OCR reaches 2% at the end of next year, they'll have done enough.

Given there's so much work for monetary policy to do, it's entirely reasonable that the market is asking whether the RBNZ might not want to get a move on, and deliver a 50bp hike next week. Odds implied by market pricing are currently at around 60/40 in favour of a 25bp, rather than 50bp hike.

It's possible, absolutely. The RBNZ is not afraid to surprise the market and cause a little (or a lot) of volatility. But it's only been eight weeks since they outlined in a speech why moving in more measured steps usually made more sense. It's appropriate to "move quickly and take large steps" when:

- the outlook for the economy has been subject to large and uncertain changes
- the risks are heavily skewed in one direction, and
- there is a material threat of not achieving your mandate.

Given recent developments, one could obviously make a case on all those fronts. But there are counter-arguments too:

- The RBNZ has had large starting point surprises, certainly. But are those the same thing as "large and uncertain changes" to the outlook? The RBNZ likely had things like financial crises and pandemic outbreaks in mind when writing that bullet, as opposed to realising they'd underestimated inflation pressures.
- The risks to inflation are looking very one-sided, absolutely. But the risks to growth and therefore employment are at least balanced, and possibly skewed to the downside. The housing market faces a very long list of headwinds and a very short list of tailwinds. Global financial markets are facing up to the realisation that interest rates will not stay low forever nor liquidity be as bountiful as it is now, and that might have consequences for real asset prices. And of course COVID could derail confidence, though certainly the overseas experience highlights that it is by no means a disinflationary shock.
- Finally, while inflation is well outside the target band and set to stay there for some time, the target of "on average over the medium term" is delightfully malleable.

In practice, central banks tend to react asymmetrically to upside and downside shocks, particularly when the zero bound is in play. The RBNZ went all out with easing in early 2020, thinking (as we all did) that we were facing a huge negative net demand shock that would threaten the bottom of the target range. When it comes to tightening monetary conditions, on the other hand, there is no theoretical limit. They can just keep going. That means that indicating a firm intention to raise the OCR by more down the track is always an alternative to raising it at double speed now. Though it isn't a risk-free strategy either, that's the choice we think they'll make. A third option that would make a lot of sense in our view would be to add a January OCR Review to the schedule. But the RBNZ would probably conclude it would be a bit late notice for that, though we think the market would actually handle it fine.

Markets

Markets will clearly be impacted by the decision itself (ie 25bps or 50bps) given that they are going into the meeting with a bob each way. We think a 50bp hike would be much more disruptive and cause greater volatility, and further upward movement, with markets likely to conclude that we could see another 50-pointer this cycle. We're not convinced that a 50bp hike would see the NZD sustain any knee-jerk reaction higher, however, especially if commentators start to ponder whether such dramatic action might shock the economy. Markets are already pricing in an expectation that the OCR reaches around 2.5% in a year's time, but that hasn't helped the Kiwi of late, thanks partly due to growing expectations that policy will be normalised elsewhere.

If the RBNZ delivers 25bp as we expect, the short end (like 1 to 3-month bills and the November OIS contract) will correct lower. But there is also some scope for 1 to 2-year swap rates to adjust lower (or at a minimum, not go higher). How they react depends less on the 25/50bp decision, and more on the RBNZ's OCR track, which as noted, could have an end-point near 3%. But even if it did, from a valuation perspective there wouldn't really be much justification for higher 1 to 2-year swap rates. If, for example, the RBNZ hikes by 25bps at every meeting until it gets to 3%, that'd see the OCR average around 1.41% and 2.12% over the next one and two years respectively. Add in your assumed Bills/OIS spread and that makes current 1 and 2-year swap rates look fully priced. Positioning might put sand in the gears of any correction, as might overall market nervousness. But the maths suggests that markets are going into this decision fully priced – and nervous.

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