ANZ Research

# RBNZ Monetary Policy Statement

26 May 2021

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Contact

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## Yikes, forecast hikes

- The RBNZ left the OCR unchanged today but reintroduced an OCR track. This implied hikes from the middle of next year, with the OCR reaching 1.78% by June 2024 – much more hawkish than expected.
- The RBNZ's forecasts for growth, employment and inflation were revised higher.
- The OCR track is in line with our view that the RBNZ will start to lift in August next year but the risks are now skewed towards earlier. We'll be watching inflation expectations data particularly closely.

### The OCR outlook

As universally expected, the OCR was left unchanged at 0.25% today with the RBNZ noting it will "take time" to sustainably hit its targets.

However, the market reaction focused squarely on the reintroduced OCR track, which showed that the RBNZ expects to start hiking the OCR around August 2022, with the track implying 150bp of hikes by mid-2024.

### RBNZ forecasts

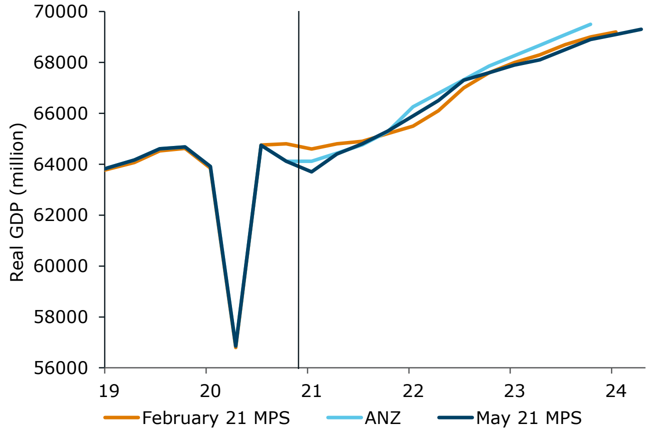
On balance, data since the February MPS (and the April Review) has been more positive than the RBNZ anticipated in its February forecasts, particularly when it comes to the housing market, labour market, commodity prices, and inflation. The downside Q1 GDP surprise feels long ago, though it has a meaningful impact on the starting point (figure 1). But there's been plenty of upside news since then. The vibe of the Bank's baseline economic outlook is better, with continued economic expansion, falling unemployment and more inflation from here.

The Bank's activity outlook is almost indistinguishable from our own in the near term, but they are marginally more pessimistic than we are heading into the medium term. That said, given our relative non-tradable inflation outlooks (figure 2), the downgrade appears inconsequential when it comes to domestic inflation pressures.

A number of key assumptions underpin the Bank's outlook, and they look pretty sensible to us:

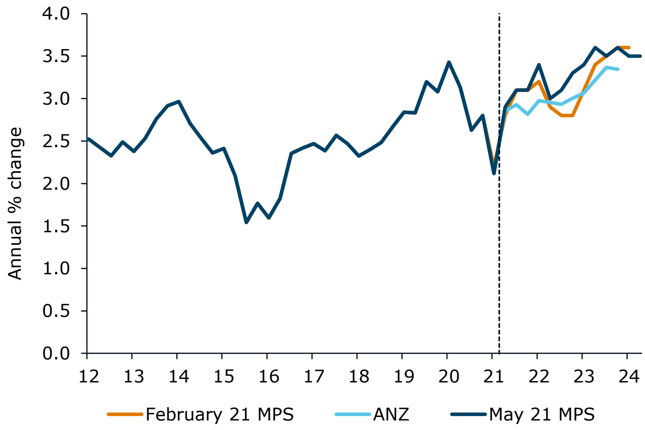
- expectations for a stronger global recovery are realised;
- supply-chain disruptions ease from the end of this year;
- the trans-Tasman bubble is positive for economic growth, and New Zealand's border restrictions with other countries ease from the start of 2022;
- government spending continues to support the economy; and
- house price inflation slows.

**Figure 1. RBNZ GDP forecast**




Source: RBNZ, Statistics NZ, ANZ Research

**Figure 2. RBNZ non-tradable CPI inflation forecast**




Source: RBNZ, Statistics NZ, ANZ Research

The labour market is where the Bank's forecast diverge from our own in a relatively meaningful way, with our forecasts showing a much quicker fall in unemployment over 2022. But as we've noted previously it's not just the unemployment rate that the RBNZ look at to gauge consistency with its maximum sustainable employment objective. Indeed the MPS noted that, "Although the latest labour market data have generally improved, measures of underutilisation and underemployment have increased. Our suite of labour market indicators suggests that while some sectors – particularly construction – are experiencing significant labour shortages, broader spare capacity remains" and that "maximum sustainable employment is not defined by a single number".

Both tradable and non-tradable inflation have been revised higher over the forecast horizon, with the latter reflecting that they now judge there to be less spare capacity in the economy (figure 3, over). Overall, we think the RBNZ's upgrade to the inflation outlook is in the right direction. We're certainly seeing upside risks to our outlook in the near term, and would say the same about the RBNZ's numbers – pricing intentions in our ANZ Business Outlook are through the roof!

The RBNZ is forecasting CPI inflation is to peak at 2.6% y/y in mid-2021, before decelerating to 1.5% by mid-2022, and gradually lifting towards a mild overshoot of 2.2% by the end of their forecast period. Bottlenecks in the supply of goods are expected to start to ease later this year, and dissipate gradually over 2022.

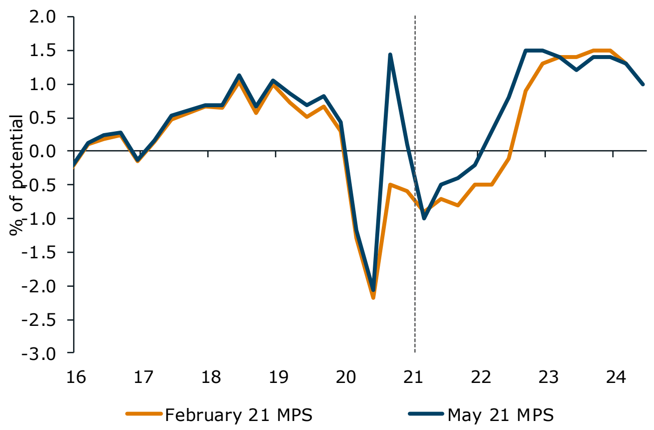
However, the RBNZ acknowledges that it is difficult to judge whether developments in inflation are likely to be temporary or persistent due to uncertainty in the underlying drivers and uncertainty in how households and businesses may react. For example, if households and businesses perceive an increase in inflation to be persistent, they are likely to respond by asking for higher wages to compensate for a higher cost of living or by setting higher prices, which can in itself lead to further inflation.

The labour shortage in New Zealand is also noted as a potential source of inflation as wage costs rise. The RBNZ says that to date these pressures have not translated to significant economy-wide wage growth, but they do expect ongoing labour market tightness to gradually increase wage inflation over the next few years.

House price inflation is forecast to go through a bigger cycle than previously expected (figure 4). This view is also very similar to our own.  House price inflation is expected to ease to nearly zero percent in quarterly terms from the middle of this year, driven down by the changes the Government announced on 23 March to tax and housing policy, along with a number of factors which impact housing supply and demand. As per the previous MPS, the RBNZ expects demand for housing to ease due to slower population growth from immigration, reintroduction and tightening of loan-to-value (LVR) restrictions, and a waning impact of the interest rate declines that occurred in 2019 and 2020. It also anticipates an increase in the supply of houses.

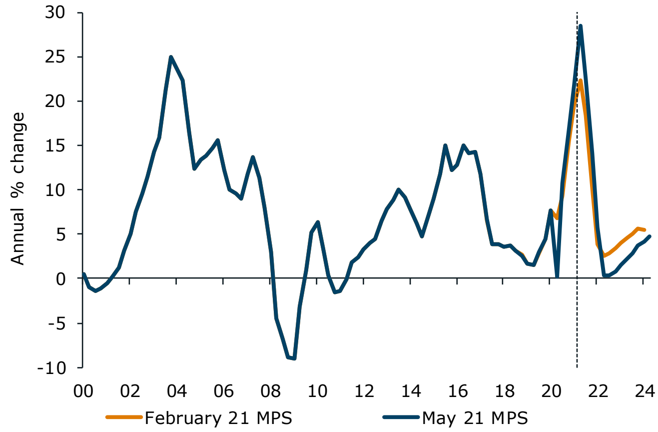
Given the politics around housing at present, it was unsurprising to see a discussion of the cause of the housing boom. The RBNZ says that policy constraints such as urban planning rules and other land use restrictions have slowed the new supply of houses in response to increasing demand that's due to both population growth and declining interest rates. They note that low interest rates should help to increase the number of homes built, policy constraints allowing. Distributional impacts of rising house prices also got a mention.

**Figure 3. The output gap**



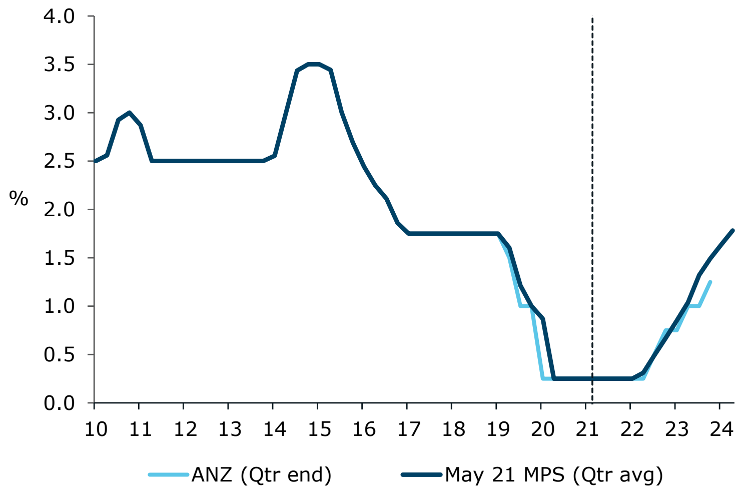

Source: RBNZ, Statistics NZ, ANZ Research

**Figure 4. House price inflation**




Source: RBNZ, CoreLogic, ANZ Research

**Figure 5. The OCR track**




Source: RBNZ, ANZ Research

The RBNZ noted that they were more confident in their outlook for the New Zealand economy, now that the risks of 'extreme downside shocks' have faded. However, it's worth noting that the New Zealand population is nowhere close to being fully vaccinated, so there's always a risk that a new outbreak of COVID could send us back into some form of lockdown, stalling the economic recovery. The RBNZ do caveat their OCR projection with the note that the OCR hikes they're forecasting are conditional on the economic outlook evolving 'broadly as expected', so higher interest rates aren't locked in – yet.

## Weighing it up

The Reserve Bank of New Zealand is calling time. Demand is clearly outstripping supply in parts of the economy, causing inflation pressure, although tourism continues to struggle. Given downside risks and challenges, the Bank still believes that ongoing strong stimulus is necessary, but no longer indefinitely.

There's a clear pattern of upward, hawkish revisions from about last August onward in everyone's forecasts, but the RBNZ's forecasts matter the most. The market is likely to extrapolate the recent pattern of revisions, testing bringing forward hiking expectations on every strong piece of data over coming months.

## Market reaction

For markets, today's MPS was pretty much only about the OCR track, which projected lift-off in Q3 2022 and 150bps of hikes by mid-2024. Full credit to the RBNZ for bringing this transparency back. While we always thought the OCR track would be upward sloping if it was to be re-introduced, it's the end-point that has caught markets by surprise. Although the RBNZ's track is remarkably similar to ours (if anything it's a touch higher), theirs goes out six months further, so optically, it looks a lot more hawkish. And in level terms, 1.78% (by June 2024) just looks a really long way from 0.25%, not to mention the US Federal Reserve's 0.125% end-of-2023 dot plot.

Not surprisingly, markets reacted swiftly, with the NZD up around 60bps and interest rates up across the board. We think these moves will likely be sustained. While the RBNZ stuck with some of its erstwhile dovish scripting (noting that the projections are conditional, and that the Bank is still operating in its "least regrets" framework), markets will struggle to see past the OCR track. Given this, we expect markets to continue to explore the upside possibilities, and that speaks to ongoing NZD strength and higher interest rates. Next week's LSAP purchases will be $350m, the same as this week, but everyone expected that, so it had no impact.

It's intuitive to think that the yield curve will bear-flatten from here (ie all NZ interest rates will rise, but short-term rates will rise by more), given that it's the prospect of a higher OCR that has perturbed the bond market, and with the NZ long end more influenced by global factors. But to the extent that this new OCR track makes it look like the RBNZ is "going it alone" with rate hikes while other central banks stand pat, that speaks to the whole curve moving higher. That said, we can't rule out that the tail may wag the dog, influencing global market expectations of whether other central banks may also take a more hawkish turn.

## Policy Assessment

Tēnā koutou katoa,

The Monetary Policy Committee agreed to maintain the current stimulatory level of monetary settings in order to meet its consumer price inflation and employment objectives. The Committee will keep the Official Cash Rate (OCR) at 0.25 percent, and the Large Scale Asset Purchase and Funding for Lending programmes unchanged.

The global economic outlook has continued to improve, with ongoing fiscal and monetary stimulus underpinning the recovery. New Zealand's commodity export prices have benefited from this rise in global demand. However, divergences in economic activity, both within and between countries, remain significant. The sustainability of the global economic recovery remains dependent on the containment of COVID-19.

The near-term economic data will continue to be highly variable. While economic growth in New Zealand slowed over the summer months following an earlier strong rebound, construction activity remains robust. The aggregate level of employment has also proved resilient, while fiscal spending continues to support domestic economic activity.

However, tourism-related business activity continues to be affected by the absence of international visitors, with the recent opening of Trans-Tasman travel expected to only partially offset revenue losses. The extent of the dampening effect of the Government's new housing policies on house price growth and hence economic activity will also take time to be observed.

Overall, our medium-term outlook for growth remains similar to the scenario presented in the February Statement. Confidence in the outlook is rising as the more extreme negative health scenarios wane given the vaccination progress globally. We remain cautious however, given ongoing virus-related restrictions in activity, the sectoral unevenness of economic recovery, and the weak level of business investment.

A range of international and domestic factors are currently resulting in rising costs for businesses and consumers. These factors include disruptions to global raw material supplies, higher oil prices, and pressure on shipping arrangements. These price pressures are likely to be temporary and are expected to abate over the course of the year.

The Committee noted that medium-term inflation and employment would likely remain below its Remit targets in the absence of prolonged monetary stimulus. The Committee also noted that while the low interest rate environment has supported house prices, other factors such as recent tax changes, the growing supply of housing, and lending restrictions, are providing offsetting pressures.

The Committee agreed to maintain its current stimulatory monetary settings until it is confident that consumer price inflation will be sustained near the 2 percent per annum target midpoint, and that employment is at its maximum sustainable level. Meeting these requirements will necessitate considerable time and patience.

Meitaki, thanks.

Adrian Orr
Governor

## Summary record of meeting

The Monetary Policy Committee discussed economic developments since the February Statement, and their implications on the outlook for inflation and employment. The Committee noted the ongoing improvement in global economic activity and the associated rise in long-term wholesale interest rates. Fiscal and monetary stimulus are continuing to underpin the global recovery. However, the varied pace of national vaccination programmes, and the re-introduction of COVID-19 containment measures in some countries, means that the growth outlook remains uncertain, and uneven within and across countries.

Economic activity in New Zealand has returned to close to its pre-COVID-19 level. The increase in economic activity has been supported by ongoing favourable domestic health outcomes. This has led to a catch up in consumer spending, supported by substantial monetary and fiscal stimulus. Improving global demand and higher prices for New Zealand's goods exports are also contributing to economic activity.

The Committee discussed the key factors underpinning the economic recovery and agreed that the outlook was unfolding broadly as outlined in the February Statement. The improvement in global and domestic economic indicators, such as New Zealand's terms of trade, have provided members more confidence in this outlook. However, the Committee agreed on the need for caution as domestic activity remains uneven across sectors of the economy.

The Committee noted areas of the economy where business activity levels remained low. The sectors most exposed to international tourism remain weak, despite the recent re-opening of travel with Australia. Business investment also remains below its pre-COVID-19 level, although recent indicators of investment intentions suggest signs of recovery.

The Committee noted that the level of employment has remained resilient. Reports of specific skill and seasonal worker shortages have the potential to put upward pressure on some wage costs. The economy is experiencing pockets of both labour shortages and employment slack, consistent with the economic disruption caused by COVID-19.

The Committee agreed that, in aggregate, the current level of employment remains below their estimates of the maximum sustainable level but expect it to converge to that level over time. They also expect to see wage growth lift as firms compete for labour, in particular given the current low levels of immigration.

The Committee noted that underlying CPI inflation currently remains slightly below their target midpoint of 2 percent per annum. A range of domestic and international factors are expected to lift headline inflation above 2 percent for a period. Members noted these factors are expected to be temporary and include higher international transport costs, disruptions to global raw material supplies and resulting higher prices for many commodities, and administrative charges.

The Committee discussed the risk that these one-off upward price pressures may promote a rise in more general inflation and inflation expectations. However, the Committee agreed that these risks to medium-term inflation were mitigated by ongoing global spare capacity and well-anchored inflation expectations.

The Committee assessed the effect of its monetary policy decisions on the Government's objective to support more sustainable house prices, as required by its Remit. It was noted that the current level of house prices result from a range of factors including low global and domestic interest rates, housing supply shortages, land use regulations, and strong investor demand.

However, the Committee acknowledged that some of the factors supporting house price growth have eased. In particular they noted the current high rate of housing construction, historically low population growth, increased loan-to-value ratio restrictions, and the Government's recent changes to housing tax and supply policies. These factors place downward pressure on the longer-run level of sustainable house prices and are consistent with a period of significantly lower house price growth.

The Committee noted risks remain to economic growth both on the upside and downside. However, they expressed greater confidence in their outlook for the economy given the reduced risk of extreme downside shocks to the economy from COVID-19.

The Committee noted that on current projections the OCR eventually increases over the medium term, but agreed that this is conditional on the economic outlook evolving broadly as anticipated. In line with their least regrets framework, members reinforced their preference to maintain the current level of monetary stimulus until they were confident that the inflation and employment objectives would be met. They agreed this would require considerable time and patience.

The Committee discussed the effectiveness of monetary policy settings since the February Statement. The Committee noted staff advice that the LSAP programme has provided substantial monetary policy stimulus to date.

Staff noted that reduced government bond issuance was placing less upward pressure on New Zealand government bond yields. This also provided less scope for LSAP purchases with the limits outlined in the letter of indemnity, specified as a percentage of government bonds outstanding. Based on current Treasury projections for the issuance of New Zealand government bonds, the Committee acknowledged that the LSAP programme could not reach the $100bn limit by June 2022. Members affirmed that this dollar figure was a limit, not a target.

Members endorsed staff continuing to adjust weekly bond purchases as appropriate, in particular taking into account market functioning. The Committee agreed that weekly changes in the LSAP purchases do not represent a change in monetary policy stance, and that any desired change in stance would be made via the usual Monetary Policy Committee communication channel.

The Committee agreed that the OCR is the preferred tool to respond to future economic developments in either direction.

The Committee agreed to maintain its current stimulatory monetary settings until it is confident that consumer price inflation will be sustained near the 2 percent per annum target midpoint, and that employment is at its maximum sustainable level. The Committee agreed it will take time before these conditions are met.

On Wednesday 26 May, the Committee reached a consensus to:

- hold the OCR at 0.25 percent;
- maintain the existing LSAP programme; and
- maintain the existing Funding for Lending Programme (FLP) conditions.

**Attendees**

Reserve Bank staff: Adrian Orr, Geoff Bascand, Christian Hawkesby, Yuong Ha
External: Bob Buckle, Peter Harris, Caroline Saunders
Observer: Bryan Chapple
Secretary: Sandeep Parekh

# Contact us

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