# RBNZ Monetary Policy Statement

18 August 2021



Contact

Sharon Zollner or David Croy for more details.

## Case sensitive

- A hawkish hold. The RBNZ today left the OCR unchanged "for now" at 0.25% "given the heightened uncertainty", while stressing that "the least regrets policy stance is to further reduce the level of monetary stimulus" – ie if we get out of this quickly, game on.
- The published OCR track implies two hikes by year-end, but it is only relevant if COVID-19 is eliminated quickly. The forecast OCR was considerably more aggressive, reaching 2.14% by September 2024.
- We have tweaked our OCR forecast timings to reflect the slower kick-off. We now expect hikes in October, November, February, May, and August next year, taking the OCR to 1.5% as before. However, our forecasts are also highly conditional on successful elimination of this outbreak.

### The OCR decision and outlook

The RBNZ today left the OCR unchanged at 0.25% "for now", "given the heightened uncertainty with the country in a lockdown". It's very clear that the RBNZ would have hiked today were it not for this week's abrupt developments, and that this is viewed as a temporary hiatus. The Committee will watch the data closely "with a view to continue to reduce the level of monetary stimulus over time."

Today's OCR decision unexpectedly became a lottery when a community outbreak of COVID-19 was discovered yesterday. Either a hike or a pause could have been easily justified. And since the RBNZ has another crack at the OCR in just six weeks, while it was probably a difficult decision, it wasn't actually a crucial one, compared to COVID-related decisions other policymakers are currently having to make around the health response.

The OCR outlook in the MPS is strictly speaking only relevant in the instance that this outbreak is dealt with successfully and promptly. That is far from a given, unfortunately, but it is our base case, and that of the RBNZ. All going well, the RBNZ expects to raise the OCR steadily, to 2.14% by the end of the forecast period, September 2024. This is a much more aggressive track than in the May MPS, where the OCR hit 1.78% by mid-2024 (though the OCR was still rising at that point).

The market was set up for a messy afternoon whatever the RBNZ decided, with pricing of 70% odds of a hike before the decision. In response to the on-hold decision, the NZD initially dropped, before rebounding on the hawkish underlying tone. Given that tone, we see limited scope for rates to fall further from here. But the only data that matters for the market in coming days will be case numbers.

### RBNZ forecasts

Forecasting in the COVID era is clearly a mug's game, and the outlook is now much more uncertain than it already was. Still, it's useful to understand the RBNZ's baseline (finalised 11 August) in order to interpret developments in the context of that.

Recent data has shown more momentum than expected, and the RBNZ's baseline economic outlook is, as anticipated, consequently stronger.

**Figure 1. RBNZ GDP forecast**

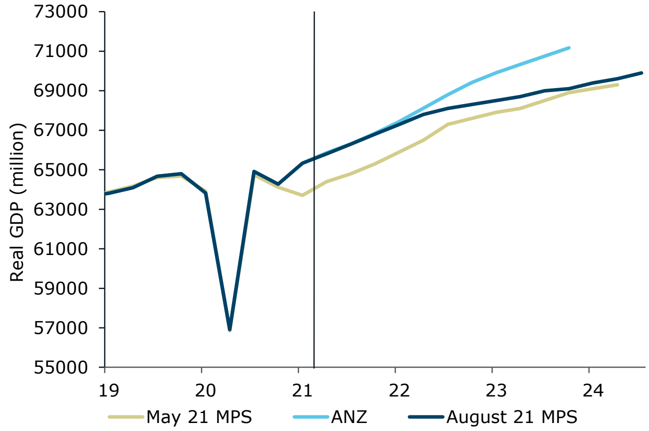
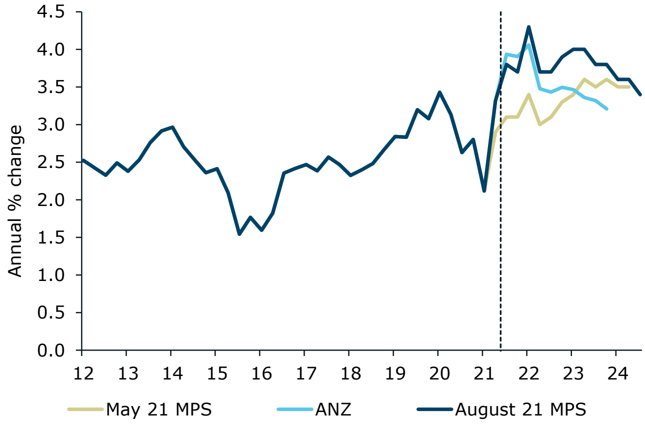



**Figure 2. RBNZ non-tradable CPI inflation forecast**




Source: RBNZ, Statistics NZ, ANZ Research

The RBNZ has a very similar near-term outlook for GDP, the unemployment rate, and inflation to our own view. But underpinning this, the Bank (and we) assume that New Zealand is predominantly at Alert Level 1 or a lower level of restrictions over the projection. Any COVID-19 outbreaks are assumed to be sporadic and quickly contained. Of note, the Bank also assumes that structural unemployment remains elevated relative to pre-COVID-19 levels, largely reflecting a skills mismatch. This has lowered the level of maximum sustainable employment, and currently, employment is estimated to be at or above its maximum sustainable level.

For a given level of unemployment, that implies stronger wage growth (which is exactly what we have seen in the Q2 labour market data). However, the Committee did express "uncertainty about whether higher wage growth will be sustained". That's certainly a valid concern, given weak wage growth after the GFC, and even today's wages print from Australia, which came in below expectations, despite very low levels of underutilisation across the ditch. But given the underlying momentum that we're seeing in inflation, inflation expectations, and the economy in general, we're expecting some considerable strength in wages over the next year. So long as that border remains closed, this labour shortage will not be easily resolved.

In the Summary Record of Meeting the Committee acknowledged the degree to which the domestic economy has become capacity constrained, with "productive capacity of the economy" (ie potential GDP) unable to keep up with demand. That's seen in their updated output gap and inflation forecasts, with the output gap assumed to be positive over most of the forecast horizon, while inflation is forecast to peak at 4.1% later this year. A positive output gap generates increasing inflationary pressure – hence the RBNZ's projection for OCR hikes over the next few years in order to tap the brakes and bring the economy back to a more sustainable growth path.

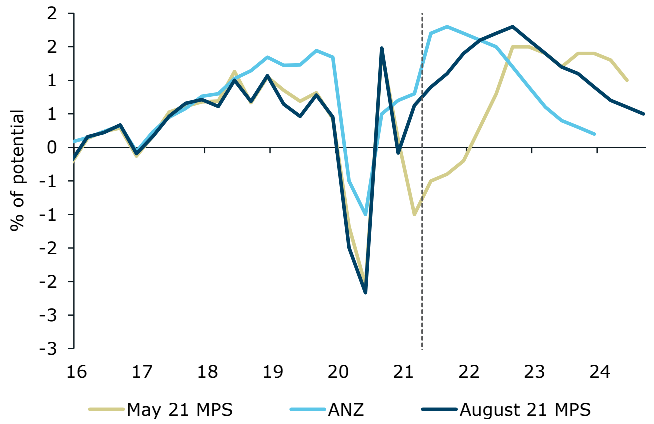
Some may argue that renewed lockdown measures mean the RBNZ's economic outlook is already out of date. And while that may prove to be the case over the next few days or weeks, we don't think the forecasts should be completely discarded until we know how the current situation unfolds.

In our view, three days of nationwide Alert Level 4 and seven days in Auckland won't leave a discernible scar in the aggregate quarterly data, nor will it stop current inflation pressure in its tracks and cause slack to open up in the labour market. Indeed, past experience shows that pent-up demand dynamics out of lockdown can be quite impressive, and businesses and households are probably more aware of that this time around.

The wage subsidy has proven to be very effective at keeping people connected to their jobs, and the additional resurgence support for businesses on top of that should mean that businesses that are struggling the most have a better chance of making it through.

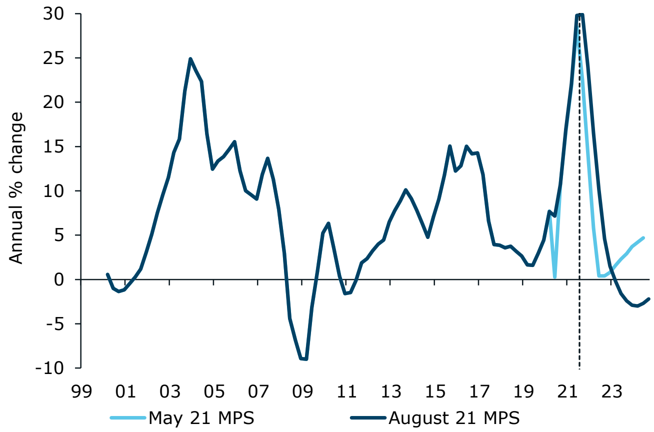
Put all that together with the fact that the broader economy was in a relatively resilient place going into this, with underlying economic momentum robust, and it's fair to say the RBNZ's forecast still have a chance of remaining broadly relevant. We have not made any changes to our economic forecasts based on the information to date, and like everyone else, will wait and see how things evolve.

**Figure 3. The output gap**



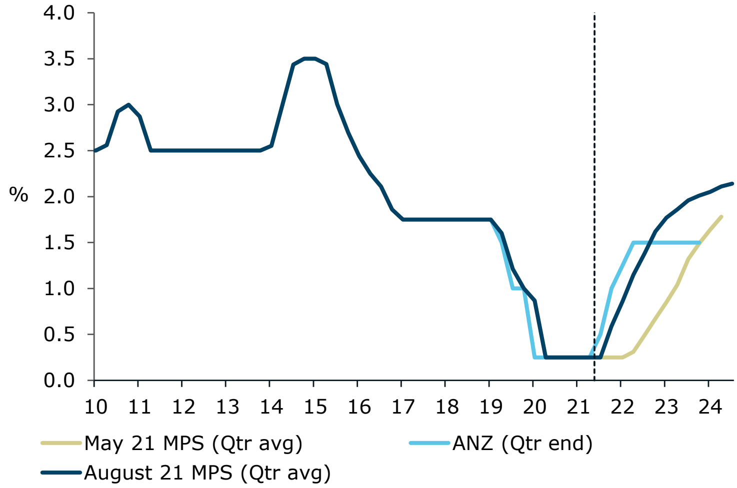

Source: RBNZ, Statistics NZ, ANZ Research

**Figure 4. House price inflation**




Source: RBNZ, CoreLogic, ANZ Research

**Figure 5. The OCR track**




Source: RBNZ, ANZ Research

The RBNZ currently estimates the neutral OCR to be around 2% - and that's consistent with the endpoint of their OCR projection, which reaches just over 2% by 2024. This neutral rate really matters for monetary policy – in fact it's as important as what's happening to inflation and employment. The neutral rate is, in the RBNZ's words, "the short-term interest rate at which monetary policy is neither expansionary nor contractionary". So for the RBNZ to essentially remove the monetary stimulus provided by the OCR, they think the OCR needs to lift to 2% before it has a neutral impact on the economy.

However, we think the RBNZ will struggle to get the OCR that high. Maybe the neutral OCR is 2% right now – but there are long-running global trends that are acting to drive neutral interest rates down across the world. We suspect 1.5% might be the highest we get in the coming hiking cycle.

## Weighing it up

The RBNZ's forecasts, like ours, may or may not be worth the paper they're written on. We'll know a lot more in a week. But optimistically assuming that we've got this, we are assuming that this is a temporary détente, and have merely pushed the timing of our OCR forecast out to reflect the later start. We are now forecasting that the RBNZ will raise the OCR in 25bp increments in October, November, February, May and August next year, to a peak of 1.5% as before.

But all forecasts are case sensitive at present. If New Zealand heads into a prolonged lockdown then a hike in October is much less likely. And if, even worse, the lockdowns don't appear to be on track to eliminate COVID-19 at all, then OCR hikes could be off the table for a considerable period, as the RBNZ focuses on shoring up confidence.

Kia kaha, stay safe.

## Market reaction

Markets were roughly split 70/30 in favour of a hike going into today's decision, and as such it was not a surprise to see the NZD and short-end interest rates move lower initially.

However, it was a hawkish hold. The higher OCR track was broadly consistent with hikes being delivered in October, November, February and May. The comment that the Committee's "least regrets policy stance is to further reduce the level of monetary stimulus" and that today's decision was made "in light of the current Level 4 lockdown and health uncertainty" is a reminder that hikes are the base case if we get through this current scare.

As such, we see limited scope for interest rates to fall much further now that they have digested the surprise of this week's Delta outbreak and today's pause. The same goes for the NZD – which is, quite rightly, treating today's decision as a postponement rather than a cancellation. But the markets will quite rightly be fixated on the daily 1pm COVID updates – it's the only data that matters for now.

# Policy Assessment

Tēnā koutou katoa, welcome all.

The Monetary Policy Committee agreed to retain the current stimulatory level of monetary settings, keeping the Official Cash Rate (OCR) at 0.25 per cent for now. Today's decision was made in the context of the Government's imposition of Level 4 COVID restrictions on activity across New Zealand.

The Committee will assess the inflation and employment outlook on an ongoing basis, with a view to continue to reduce the level of monetary stimulus over time so as to best meet their policy remit. This follows the recent halting of additional government bond purchases under the Large Scale Asset Purchase (LSAP) programme in July.

Global monetary and fiscal settings remain at accommodative levels, supporting international spending and investment. Rising vaccination rates across many countries have provided economic impetus. The rise in activity has continued to support demand and prices for New Zealand's export commodities.

However, the need to reinstate COVID-19 containment measures in some regions highlights the serious health and economic risks posed by the virus. Persistent and elevated health risks are promoting ongoing global supply chain disruptions, and are acting to constrain productive capacity and prolong inflationary pressures. Today's re-introduction of Level 4 restrictions to activity across New Zealand is a stark example of how unpredictable and disruptive the virus is proving to be.

The Committee noted that the New Zealand economy had rebounded more strongly than most countries, with less domestic disruption caused by COVID-19 to date. Employment is currently at or above its maximum sustainable level, and consumer price inflation expectations remain anchored near 2 percent, the midpoint of the target range.

Recent data for the New Zealand economy suggest demand is robust and the economic recovery has broadened, despite some weakness persisting in the sectors most exposed to international tourism. Household spending and construction activity are at high levels and continue to grow, and business investment is responding to increased demand.

Capacity pressures are now evident in the economy, particularly in the labour market where job vacancies remain high despite the recent decline in unemployment and underemployment. Wages are rising consistent with the tight labour market conditions.

Broader inflation pressures are being accentuated in the near-term by one-off price rises such as higher oil prices, and temporary factors such as supply shortfalls and higher transport costs. Near-term consumer price inflation is expected to rise above the Committee's target range before returning towards the 2 percent midpoint around mid-2022.

The Committee agreed they are confident of meeting their inflation and employment remit with less need for the existing level of monetary stimulus. However, the Committee remains alert to the supply disruptions that COVID-19 can create, and the dampening effect this can have on confidence. House prices are also above their sustainable level, heightening the risk of a price correction as supply increases.

The Committee agreed that their least regrets policy stance is to further reduce the level of monetary stimulus so as to anchor inflation expectations and continue to contribute to maximum sustainable employment. They agreed, however, to keep the OCR unchanged at this meeting given the heightened uncertainty with the country in a lockdown.

Meitaki, thanks.

Adrian Orr
Governor

## Summary record of meeting

The Monetary Policy Committee discussed economic developments since the May Statement. The Committee noted that the global economy has continued to recover, supported by rising vaccination rates in many countries, a gradual relaxation of mobility restrictions, and continued monetary and fiscal support.

The Committee noted the considerable uncertainty that exists regarding the longer-run impacts of COVID-19, particularly with the emergence of new variants. Globally, periods of health-related mobility restriction are likely to continue for some time, creating ongoing short-term economic disruptions, supply cost pressures, and lower productive capacity.

The Committee agreed that in New Zealand the recent economic data suggest domestic demand is robust and that the economic recovery has broadened in recent months. While weakness still persists in sectors most heavily exposed to international tourism, activity in most industries now exceeds pre-COVID levels.

Domestic economic activity has been underpinned by strong household spending, high levels of construction, and strong demand for New Zealand's commodity exports. Recent data has also shown a pick-up in business investment, which broadens the base of aggregate demand and suggests businesses are responding to emerging capacity constraints.

The Committee noted uncertainty related to the emergence of new cases of COVID-19 in the community and the move back into Alert Level 4. The reinstatement of the Government Wage Subsidy Scheme and COVID-19 Resurgence Support Payments is expected to significantly buffer the loss of income associated with the lockdown.

The Committee agreed that capacity constraints were building in the economy. Pressures are particularly acute in the labour market, where job vacancies remain high alongside declines in unemployment. Falling underemployment provides a greater level of confidence that spare capacity is being absorbed. Employment is assessed as being at or above its maximum sustainable level in the current environment.

Wage inflation has increased in line with the tightening in the labour market, but the Committee expressed uncertainty about whether higher wage growth will be sustained.

The Committee noted that capacity constraints are contributing to rising headline inflation. Mirroring global developments, inflationary pressure in New Zealand has been accentuated in the near term by one-off factors such as higher oil prices, and temporary factors such as supply shortfalls and rising transport costs. This is expected to push inflation above 4 percent in the near-term, before returning towards the 2 percent midpoint of the target band from mid-2022. Medium and long-term inflation expectations remain anchored at 2 percent.

The Committee reflected that experience over the past 12 months has provided more confidence about the resilience of domestic demand in the face of health-related restrictions. The Government Wage Subsidy proved effective in supporting domestic incomes and providing job security through periods of lockdown, which has enabled a rapid recovery in consumer spending. This scheme has been rapidly reinstated in light of the current lockdown. While some households suffered income losses and accumulated debt, many households retain a larger buffer of savings, which could provide ongoing support to consumption.

The Committee acknowledged that restrictions on the movement of people across the New Zealand border will only be removed gradually, and subject to ongoing health-related uncertainty. However, they also agreed that, to date, increased domestic spending has provided a significant offset to the loss of international tourism earnings. The closure of the border has also reduced international labour mobility, creating capacity shortages in some industries that have traditionally been reliant on migrant labour.

In light of this experience, members expressed caution about the level of remaining supply capacity in the New Zealand economy. The economic disruption caused by the ongoing global health issues has increased skill mismatches, which has likely reduced maximum sustainable employment in the near term. The Committee discussed the risk that the productive capacity of the economy is lagging domestic demand, which could lead to more persistent inflation pressure.

The Committee discussed the current, and risk of future, outbreaks of COVID-19 in New Zealand, and how monetary policy should respond. The Committee agreed that fiscal policy (government spending and transfer payments) has proved to be a very effective tool to respond to any immediate reduction in demand in the event of outbreaks. A monetary policy response may be required if a health-related lockdown has a more enduring impact on inflation and employment.

As required by their Remit, members assessed the impact of monetary policy on the Government's objective to support more sustainable house prices. The Committee noted the Reserve Bank's assessment that the level of house prices is currently unsustainable. Members noted that the Reserve Bank is currently consulting on further bank lending restrictions to help mitigate the financial stability risks associated with unsustainable house prices.

The Committee noted that a number of factors are expected to weigh on house prices over the medium term. These include strong house building, slower population growth, changes to tax settings, and the ongoing impacts of tighter bank lending rules. Rising mortgage interest rates, as monetary stimulus is reduced, would also constrain house prices to a more sustainable level. Members expressed uncertainty about how quickly momentum in the housing market will recede and noted a risk that any continued near-term price growth could lead to sharper falls in house prices in the future.

The Committee reiterated that the OCR is currently the preferred tool to adjust the level of stimulus in the economy. The principles governing the suite of monetary policy tools will continue to guide their use. In line with those principles, the Funding for Lending Programme (FLP) will remain in place under its current terms until the drawdown window expires next year. The Committee directed staff to develop an operational strategy to help inform decisions regarding the management of Government and Local Government Funding Agency (LGFA) bonds purchased under the Large Scale Asset Purchase (LSAP) programme, consistent with the Committee's desired stance of policy and supporting the functioning of markets.

The Committee discussed the stance of monetary policy. Members noted that they now had more confidence that rising capacity pressures will feed through into inflation, and that employment is at its maximum sustainable level. Members concluded that they could continue removing monetary stimulus, following their decision to halt additional purchases of Government bonds under the LSAP programme at their July meeting.

The Committee discussed the merits of an increase in the OCR at this meeting and considered the implications of alternative sequencing of OCR changes over time. The Committee agreed that their least regrets policy stance is to further reduce monetary policy stimulus to reduce the risk that inflation expectations become unanchored. However in light of the current Level 4 lockdown and health uncertainty the Committee agreed to leave the OCR unchanged at this meeting.

On Wednesday 18 August, the Committee reached a consensus to:

- Maintain the OCR at 0.25 percent;
- Direct staff to develop an operational strategy to inform decisions on the management of Government and LGFA bonds purchased under the LSAP programme; and
- Maintain the existing Funding for Lending Programme conditions.

**Attendees**

Reserve Bank staff: Adrian Orr, Geoff Bascand, Christian Hawkesby, Yuong Ha

External: Bob Buckle, Peter Harris, Caroline Saunders

Observer: Bryan Chapple

Secretary: Chris Bloor.

# Contact us

## Meet the team

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

**Sharon Zollner**
Chief Economist

Follow Sharon on Twitter
@sharon_zollner

Telephone: +64 27 664 3554
Email: sharon.zollner@anz.com

General enquiries:
research@anz.com

Follow ANZ Research
@ANZ_Research (global)

**David Croy**
Senior Strategist

Market developments, interest rates, FX, unconventional monetary policy, liaison with market participants.

Telephone: +64 4 576 1022
Email: david.croy@anz.com

**Susan Kilsby**
Agricultural Economist

Primary industry developments and outlook, structural change and regulation, liaison with industry.

Telephone: +64 21 633 469
Email: susan.kilsby@anz.com

**Liz Kendall (maternity leave)**
Senior Economist

Research co-ordinator, publication strategy, property market analysis, monetary and prudential policy.

Telephone: +64 27 240 9969
Email: elizabeth.kendall@anz.com

**Miles Workman**
Senior Economist

Macroeconomic forecast co-ordinator, fiscal policy, economic risk assessment and credit developments.

Telephone: +64 21 661 792
Email: miles.workman@anz.com

**Finn Robinson**
Economist

Macroeconomic forecasting, economic developments, labour market dynamics, inflation and monetary policy.

Telephone: +64 21 629 553
Email: finn.robinson@anz.com

**Kyle Uerata**
Economic Statistician

Economic statistics, ANZ proprietary data (including ANZ Business Outlook), data capability and infrastructure.

Telephone: +64 21 633 894
Email: kyle.uerata@anz.com

**Natalie Denne**
PA / Desktop Publisher

Business management, general enquiries, mailing lists, publications, chief economist's diary.

Telephone: +64 21 253 6808
Email: natalie.denne@anz.com

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