ANZ Research

NZ OCR Forecast Update: back-to-back 50-pointers

8 March 2022

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Contact

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Bottom line

- We have revised our Official Cash Rate (OCR) call and are now forecasting back-to-back 50bp hikes in both April and May.
- We now see the OCR reaching a peak of 3.5% in April 2023 (3% previously).
- This is despite clearly mounting downside growth risks, both in New Zealand and globally. We now expect house prices to fall 10% this year.
- The OCR call change comes primarily on the back of our updated CPI forecasts that now have inflation peaking at a broad-based 7.4% in Q2, rather than the RBNZ's MPS forecast of a 6.6% peak in Q1.
- The RBNZ would prefer to look through oil price shocks, but right now, with inflation expectations so high and rising, they just can't.
- The RBNZ Monetary Policy Committee affirmed in its February Summary Record of Meeting that "it was willing to move the OCR in larger increments if required over coming quarters." Game on.

Ups…

It's really not long since the February MPS but things have moved fast. There have been plenty of upside surprises on the inflation front, which have driven us to revise up our CPI forecast significantly.

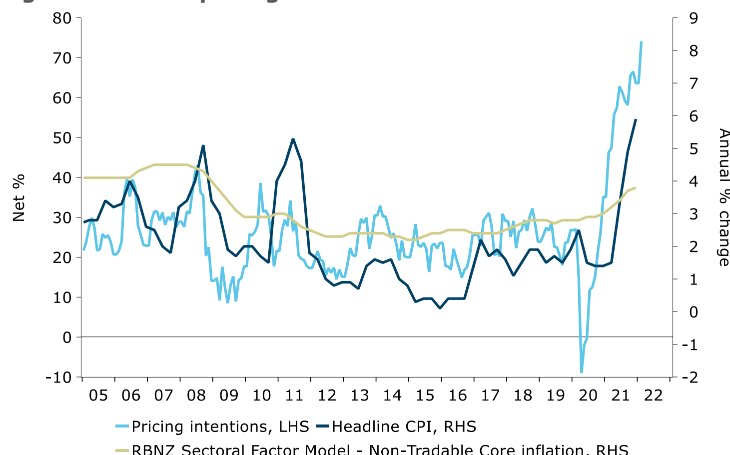
Oil is the biggie, with crude futures soaring to nearly USD140 at one point this week, rather than starting a journey back to USD80 as the RBNZ assumed back in February.

Given extreme volatility, we don't have much confidence forecasting oil price moves from here. But there seems little hope of the Ukraine situation being resolved quickly, and we do know sharply increasing fuel prices will be particularly visible. Indeed, analysis shows that petrol prices have a much bigger impact on household inflation expectations than their weight in the Consumer Price Index alone would suggest. And that's where things get highly problematic for the RBNZ – since inflation expectations are already uncomfortably high, this oil price surge could easily be the catalyst for them becoming unanchored from 2%. What's more, given the extreme tightness in the labour market, rising inflation expectations could then feed into a wage-price spiral, a risk the RBNZ placed front and centre in the February MPS.

It's not just oil – we've also seen a swath of other commodity prices jump, including **dairy prices**. The Global Dairy Trade price index just hit its highest level since 2013. Dairy commodities are trading at an average price of USD5,065 versus an RBNZ assumption of a moderation to USD3,500/t over the forecast period. While the inflation impact of export prices is smaller and less direct than with import prices, it still matters. A structural VAR model suggests that a 5% upward surprise on the ANZ commodity price index (a 'normal' quarterly move) adds 0.5% to consumer prices, and takes over a year to fully flow through the economy.

As well as all that, firms' **pricing intentions** jumped again in the latest ANZ Business Outlook survey – a net 74% of firms are intending to raise their prices. That's absolutely unprecedented, and pricing intentions tend to be an excellent guide to inflation dynamics (figure 1). And given energy is an input into pretty much every good or service somewhere along the line, pricing intentions could well go higher yet.

Figure 1. ANZBO pricing intentions and CPI inflation



Source: RBNZ, Stats NZ, Macrobond, ANZ Research

And downs

While inflation surprises have been all to the upside, the same can't be said of activity indicators. Indeed, the broader macroeconomic mood is souring. The RBNZ was probably startled by the size of the fall in **sentiment** amongst business, and particularly, consumers last week. We certainly were. But it might just be temporary Omicron impacts, so the RBNZ is likely to put it to one side for now.

Evidence continues to mount that the housing market is slowing more rapidly than their forecast, and things could get a little messy there. Indeed, now that we are anticipating more aggressive OCR hikes up front, **we expect house prices to fall 10%** (rather than 7%) over 2022. But importantly, we'd still classify this updated forecast as a soft landing, given the giddying-high starting point.

Still, in the context of double-digit house price falls, back-to-back 50bp hikes would seem a risky choice. They are! But there aren't any low-risk policy options anymore. And it's worth noting that the RBNZ was already forecasting hiking right into the headwind of falling house prices. We're already in uncharted territory – it's now just a question of degree.

The fact is, it's just no longer true that mild downside growth surprises will derail OCR hikes. That's a difficult world to get your head around – for economists, homeowners and businesses. It's just not the way things have been for a very long time.

Climbing up an oily slide

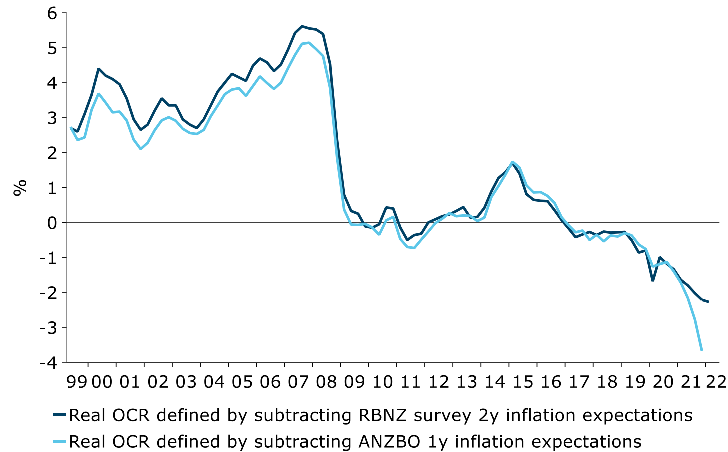
It's worth taking a moment to highlight how quickly things have evolved, and how far behind the game the RBNZ is. Since 6 October 2021:

- The OCR has gone up 75bp, to 1.0%;
- CPI inflation has risen 100bp;
- 2-year-ahead inflation expectations (RBNZ survey) have risen 100bp;
- The RBNZ's forecast peak in CPI inflation has risen 250bp, to 6.6%;

- Our own forecast peak in CPI inflation, taking into account post-MPS developments (most crucially oil) has risen 330bp, to 7.4%.

However you want to define it, the real OCR has continued to slide even as the RBNZ has tightened. Figure 2 shows the real OCR, here calculated by deflating the nominal OCR by 2-year-ahead inflation expectations from the RBNZ survey, or 1-year-ahead expectations from the ANZ Business Outlook survey.

Figure 2. The real OCR



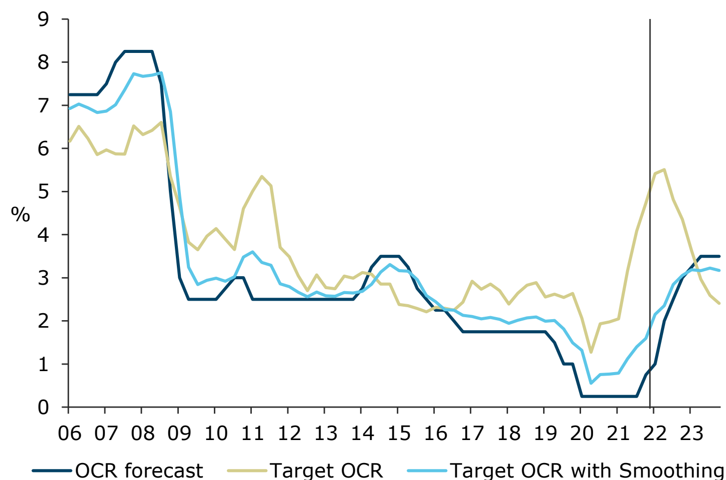
Source: RBNZ, Macrobond, ANZ Research

The RBNZ can get away with a short period of deeply negative real interest rates. It's not about to cause everyone to throw caution to the wind and borrow to the hilt, with so much uncertainty around, and the housing market in retreat, due to not only higher (nominal) mortgage rates but also affordability, credit availability, Omicron, and increased supply.

But real interest rates do need to normalise, and if that's not going to happen by the disinflation fairies waving their wands, it'll need to be achieved by raising the OCR.

To illustrate how behind the curve monetary policy is, we can use the Taylor Rule. It describes policy in a pretty simple way, assuming it reacts just to the output gap (whether the economy is running hot or cold relative to trend) and the inflation divergence from target. And then some smoothing, to reflect that there's value in being predictable. Just those three things do pretty well at explaining past policy decisions. The model shows what the OCR would be, were policy being run according to the same 'rule' as it implicitly has been in the past (without any kind of judgement on whether this would be optimal).

Figure 3. The Taylor Rule



Source: RBNZ, ANZ Research

Figure 3 shows that if the RBNZ had been following its typical "reaction function", the OCR would have been raised far earlier than it in fact was – and would be sitting well around 2.5% by now. With the OCR at 1% the RBNZ is at least 150 basis points (6 standard hikes) behind the game. Naturally the massive uncertainty around COVID resulted in caution. But it's now catch-up time, uncertainty or no, under the "least regrets" framework. Because losing your inflation targeting credibility is pretty hard to top, as far as policy regrets go.

With inflation heading to almost 7½%, the wiggle room to add judgement, to give growth a chance, to take a punt on allowing inflation to return to target a bit more slowly, to see whether inflation shocks dissipate on their own, is gone. With inflation-targeting credibility itself on the line, nice-to-haves – like treading cautiously because of the risk of a harder economic landing than intended – have to be dumped over the side. Any upside surprise to inflation, from any source, will have to go straight into the RBNZ's forecast OCR track – and their actual OCR decisions.

That said, it is entirely plausible that the RBNZ, and we, end up forecasting the OCR to go considerably higher than it actually gets to, given the ever-present risk of an unforecastable global side-swipe.

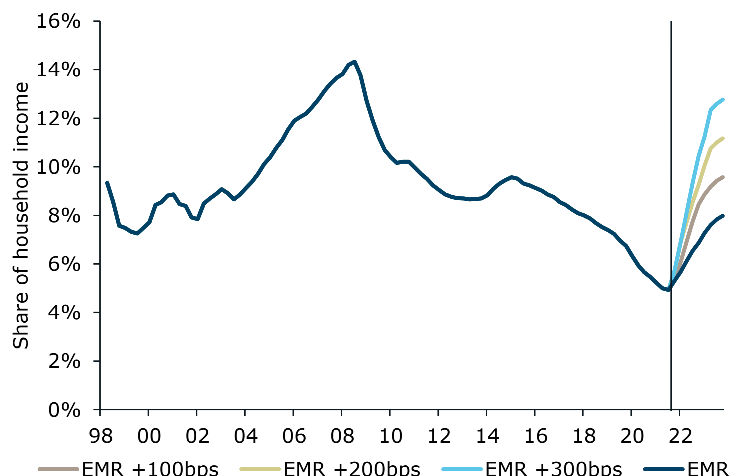
So why stop at 3.5%?

If inflation risks are so severe, then why won't the Reserve Bank just carry on and raise the OCR to 5% or 6%?

The OCR may well get there, in the fullness of time, given our sense that climate change and deglobalisation spell the definitive end of the very-low-inflation era. But it seems more likely to be in the next cycle – we've got the aftermath of a housing boom to tidy up first. So let's turn to the question of what is likely to cap the OCR in this cycle.

In our latest Property Focus we looked at the question of rising interest rates and debt serviceability. We calculated that even at an effective mortgage rate (EMR) 300bp higher than the peak implied by our then-forecast of a peak OCR of 3%, debt servicing would take a lower proportion of household income than in 2008 (figure 4). That's not to say that all households would be fine and dandy in that scenario, of course. But it's not likely to be the household debt-servicing burden that causes things to 'break' in terms of a hard landing, in and of itself.

Figure 4: Household debt servicing scenarios
(assuming household income growth of 5% each year)



Source: RBNZ, ANZ Research

Rather, it could be the fall in house prices that limits the tightening. With our new forecast of the OCR reaching 3.5% in a front-loaded fashion, we're now forecasting house prices falls of 10% over 2022. If we were forecasting an OCR of 5% or 6% we'd be looking at much scarier numbers than that. The impacts of that on household spending and on the construction sector are hard to gauge, but would seem likely to be very significant, with flow-on impacts into employment that would seem more than likely to bring about a hard landing and stop the OCR in its tracks (along with a bunch of other things).

That kind of dynamic is exceptionally difficult to forecast, with direct flow-on uncertainty into the endpoint for the OCR. A very wide range of outcomes is plausible.

Strategy considerations

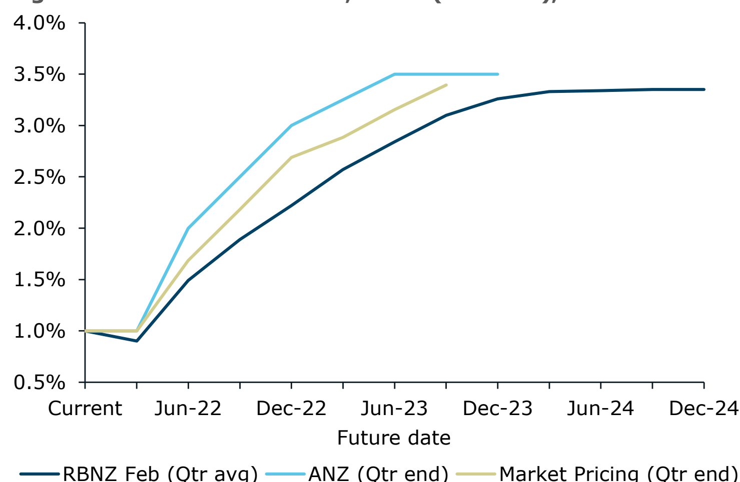
The Monetary Policy Committee affirmed in its February Summary Record of Meeting that "it was willing to move the OCR in larger increments if required over coming quarters." So they've cleared the path.

The Committee could choose to wait until the release of CPI between the April Review and the May MPS to deliver a 50bp hike. But we know about the rise in oil prices now. And the direct impact of that is one of the easier components of the CPI to forecast (directionally at least). So there's little to be gained from waiting for the smoking gun.

And once the RBNZ delivers one 50bp hike, the market will rush to price another in May, giving the RBNZ a free hit we think they'll be happy to take.

Figure 5 shows our updated OCR forecast compared to market pricing and the RBNZ's OCR forecast. The market is already pricing a significant chance of a 50bp hike, but there are clear upside risks to rates if the markets gravitate to our view of two 50bp hikes back to back.

Figure 5. OCR forecasts: ANZ, RBNZ (Feb MPS), Current market pricing



Source: RBNZ, Bloomberg, ANZ Research

A final point is that the RBNZ is planning on gradually selling its NZGB holdings back to New Zealand Debt Management (NZDM), in an effort to shrink its balance sheet. This 'quantitative tightening' means, all else equal, that NZDM may need to issue more bonds themselves in order to make those purchases from the RBNZ. That could put upwards pressure on long-term interest rates – possibly reducing how far the OCR needs to lift. But it's highly uncertain how shrinking the balance sheet will impact the economy in practice – and the RBNZ has been clear that the OCR should be the primary monetary policy tool going forward.

To be honest, it’s not clear that from this starting point there even exists a path for the OCR that gets inflation back to target in an acceptable timeframe while avoiding a hard landing – and that’s emerging as a truly global theme, which ups the ante even more. Here’s hoping. But the buck stops with inflation, and the only way for the OCR is up.

NZ interest rates

	Current	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
NZ OCR	1.00	1.00	2.00	2.50	3.00	3.25	3.50	3.50	3.50
90-day bills	1.34	1.92	2.52	3.02	3.27	3.60	3.60	3.60	3.60
2yr bond	2.32	2.54	2.94	3.08	3.14	3.18	3.18	3.20	3.20
10yr bond	2.74	3.00	3.20	3.30	3.65	3.75	4.00	4.00	4.00
NZ-US 10yr Spread	104	110	120	130	140	150	150	150	150

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