ASB

Economic Note

RBNZ November Monetary Policy Statement

24 November 2021

Considered Steps

- The RBNZ lifted the OCR by 25bps to 0.75% and signalled lifting the OCR in "considered steps" over 2022.
- The outlook is still inherently uncertain and fluid, though against that inflation pressures are steadily building.
- The RBNZ flagged an OCR end-point around 2.6%. This is consistent with our view that the recent run-up in market pricing and NZ yields had gotten too far ahead of itself.

The RBNZ's OCR decision and statement were in line with our expectations, though a little more measured than the market had been factoring in. The run of very strong data had markets pricing in some chance of a 50bp increase today, rather than the 25bp that eventuated. The RBNZ has flagged it has a lot of work to do still, with a forecast OCR peak of 2.6%, but is most likely to proceed steadily in 25bp increments.

The RBNZ acknowledged key medium-term supports to the outlook. These include household and business balance sheet strength, ongoing fiscal policy support, and strong terms of trade. This has increased the RBNZ's confidence that economic activity will recover quickly as alert level restrictions ease. However, the RBNZ emphasised that with a global pandemic still around, the outlook is still inherently uncertain and fluid. Importantly, the RBNZ will be watching closely how the economy adjusts to the ongoing disruption from COVID-19.

The focus is increasingly turning to: how far will the OCR eventually go? Financial markets had recently been pricing in an OCR peak of around 3%, and (despite some pull back in pricing today) are still factoring in that the OCR goes up further than the RBNZ's latest forecast. In contrast, we are still forecasting a 2% OCR peak – though freely acknowledge there is a lot of uncertainty ahead. We are mindful, though, that borrowers could prove quite sensitive to rising interest rates, and that the RBNZ may avoid being too dogmatic in the future about swiftly driving inflation back down to 2%. Moreover, the RBNZ has a lot of good news baked into its near-term outlook. In sum, we do see the market as pretty richly priced for good news, which makes the certainty of fixing the cost of borrowing as coming with a price.

The overall message: steadily up

The RBNZ is navigating the near-term uncertainties against a medium-term picture that says "OCR up". Events to date have once again prompted the RBNZ to raise its assessment of future inflation pressures. But, as NZ enters the Traffic Light System and grapples with COVID-19 spreading around the country, the great unknown is how well the health system will cope and how tight health restrictions will need to be (particularly come winter next year). Moreover, households and businesses might become more cautious for a spell while COVID spreads.

These COVID uncertainties were a reason for the RBNZ to hold off from lifting the OCR by more than 25bp today. But the RBNZ is clear on the need to keep steadily lifting interest rates. Its forecast OCR peak of 2.6% is up from 2.1% in the August Monetary Policy Statement (MPS), which now implies the OCR ending on the contractionary side of the neutral level (circa 2%). **We still expect the RBNZ will lift the OCR to a peak of 2% by the end of 2022.**

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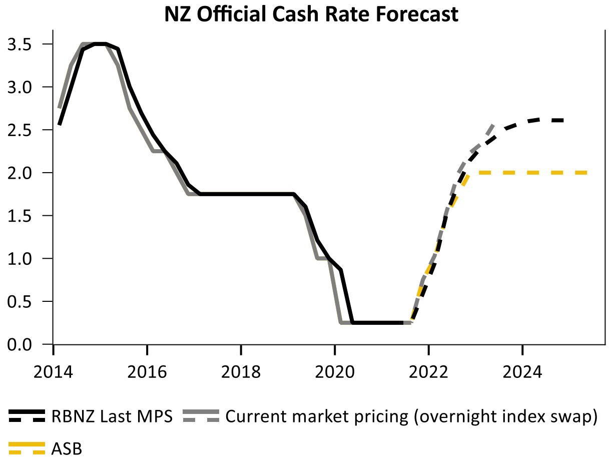
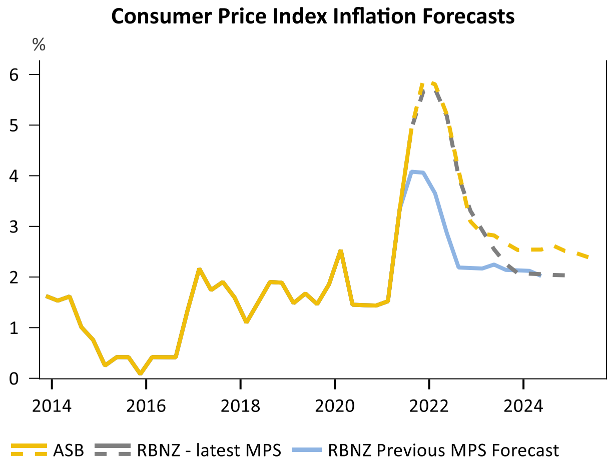
It is very likely that the RBNZ will continue to lift in steady 25bp increments next year. If there ever was a time to lift by 50bp it was now: the OCR is still well below neutral; the run of data has been unequivocally strong; and it is a 3-month wait until the next scheduled OCR decision.



Source: Macrobond, ASB

Inflation outlook up

Once again, the RBNZ has significantly revised up the NZ inflation outlook. This reflects a myriad of sources, including rising capacity pressures, continued bottlenecks in global and local supply chains and higher commodity prices. The RBNZ now expects annual CPI inflation to peak at 5.7% in the December 2021 year and remain outside the 1-3% inflation target band until 2023. The RBNZ then expects annual inflation to moderate towards 2% over the latter half of the projection period, as the boost from commodity prices (including oil) wanes, supply-chain disruptions ease, and higher interest rates slow domestic inflation. The RBNZ, however, notes there are risks to the outlook for inflation. We have a similar CPI profile to the RBNZ, but see the risk that some sources of inflation pressure persist for slightly longer before abating.



Source: Macrobond, ASB

Labour market tight

The RBNZ adjudged that, despite recent lockdowns, capacity pressures in the economy have continued to tighten. Of note, employment is now deemed to be above the maximum sustainable employment (MSE) level, with unemployment and underutilisation at their lowest levels in over a decade. With the RBNZ assuming that access to workers from abroad will remain limited by border restrictions during at least the first half of 2022, capacity pressures in the labour market are expected to remain intense, with net migration assumed to increase gradually as border restrictions ease. Employment is expected to remain above its MSE level over the projection horizon, but to return towards MSE over the projection as capacity pressures ease. Wage growth has also picked up, although it has mostly been well behaved and has been more than offset by rising consumer prices. We largely concur with the RBNZ's assessment but note that the employment and wage outlook remain highly uncertain and sensitive to changes in the border restrictions, and the relative attractiveness of NZ as a post COVID-19 destination to live and work. Proof will be in the pudding in the first half of the year, now that NZ will make it much easier for people to (re)enter the country.

Peaky about the peak

Now that the OCR is going up and with further increases to come, the attention is increasingly going on how high the OCR will eventually peak. We do see the risk that markets have got a little ahead of themselves in factoring in an OCR peak near 3%. Nevertheless, we freely acknowledge there is a huge amount of uncertainty about the OCR outlook – which has already changed dramatically in a short space of time.

Some reasons for believing the OCR peak will eventually be below market pricing are:

- Borrowers may turn out to be quite sensitive to rising interest rates, particularly given how big the relative increases in interest payments will be and that a significant number of new borrowers will have only ever known a falling OCR environment;
- Wage inflation is rising, but not as fast as the cost of living – and a hit to disposable income is another

headwind many households are facing this coming year;

- The RBNZ may be comfortable to err on the side of tolerating a gradual fall of inflation back to the 2% mid-point than its forecasts imply, given that some strong drivers at present are ‘transitory’;
- The RBNZ’s own outlook has a fair degree of good news already baked in, via a sharp GDP rebound out of the lockdown and further falls in unemployment from the current record low.

Although we learned a long time ago never to say never, the cost of gaining certainty as a borrower does look high at present. Essentially, fixing at the moment is about buying insurance against interest rates going even higher than what amounts to a pretty high peak. That may still be of value for some borrowers, depending on their circumstances, but the horse has well and truly bolted on being able to obtain protection from a substantial degree of monetary tightening.

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