Economic Note

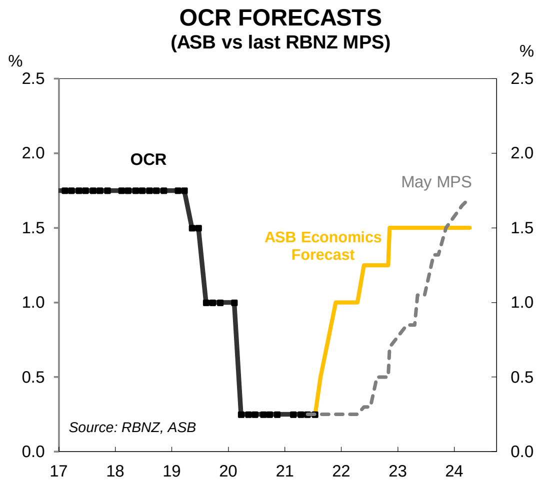
RBNZ August Monetary Policy Statement Preview

12 August 2021

The fastest gun in the West

- The latest economic data show inflationary pressures lifting dramatically and the labour market strengthening.
- The balance of risks has shifted and the 'least regrets' approach for the RBNZ is now to begin hiking sooner rather than later.
- **We now expect the RBNZ to lift the OCR by 25bp to 0.50% at next week's August Monetary Policy Statement, with the OCR rising to 1.00% by the end of the year.**

Since we last heard from the RBNZ back in July, the latest data continue to point to a strengthening economic outlook, typified by a labour market quickly heading toward full employment and sharp lifts in inflationary pressures. Both inflation and the labour market look set to run considerably hotter than the RBNZ's previous round of forecasts, when it envisaged the OCR staying on hold as late August 2022.



Throughout the pandemic, the RBNZ has hewed to a cautious mantra, preaching the gospel of 'least regrets.' Most of the time, this has meant taking stronger economic data with a grain of salt given all the residual uncertainty and keeping monetary policy accordingly free and easy. But the resilience of the labour market and the uptick in inflationary pressures have been such that balance of risks has now shifted completely in the other direction. The Bank is now at greater risk of letting inflation exceed the target band for a prolonged period than of snuffing out the recovery with premature tightening. Throwing a bit more cold water on the housing market wouldn't hurt either.

The upshot is that hiking the OCR sooner rather than later is now the 'least regrets' approach for the Bank. Having cleared the path by winding up the LSAP its last meeting, we expect it to pull the trigger with a 25bps lift to 0.50% next week. Further hikes should follow in October and November, taking the OCR to 1% by the end of the year.

Our call suggests the RBNZ will be much quicker on the draw than virtually any other major central bank, but the data mean such a move is justified. Swift and competent action by key health and economic policymakers (as well as no small measure of good luck) has seen the country weather the COVID storm far better than nearly anywhere else. The time for emergency policy settings has passed, with the OCR set to return to return to a more 'normal' setting (though 'normal' is a relative term – we still expect the cash rate to peak at a historically low level). Remaining pockets of regional and sectoral inequality are better addressed through fiscal measures than the blunt tool of monetary policy. **Higher interest rates beckon, and borrowers who have taken advantage of their rock bottom levels over the past eighteen months should prepare themselves accordingly.**

Nathaniel Keall – Economist – (649) 301 5720 nathaniel.keall@asb.co.nz

Nick Tuffley – Chief Economist – 021 891 881 (649) 301 5659 nick.tuffley@asb.co.nz

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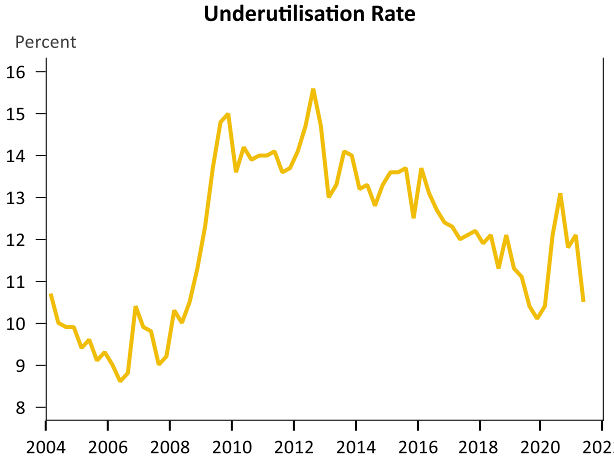
Data Wrap: Running hot

We last heard from the RBNZ at July's Monetary Policy Review, where the bank made an unmistakable shift in a hawkish direction by winding up the Large Scale Asset Programme. In that relatively short period of time, we've had a number of developments, all of which have supported the case for tightening up monetary policy sooner rather than later:

- CPI data for Q2 were much, much stronger than the RBNZ's forecasts, with annual inflation hitting 3.3%. Of concern for the RBNZ, the data showed evidence domestically-generated inflationary pressures are stirring.

- The labour market over Q2 was also in a much, much better position than the RBNZ envisaged, with the unemployment rate falling to 4% and upward pressure on wages evident. Notably, the RBNZ's three preferred measures of labour market slack – the underutilisation rate, the Maori unemployment rate and the unemployment rate for 20–24-year-olds all dropped back near pre-COVID levels.



Source: Macrobond, ASB

- Business surveys though July and August continued to show that finding and retaining staff remain major headwinds for businesses, while pricing and inflation expectations are hitting multi-year highs.

Our own post-COVID estimate of the 'non-inflation accelerating unemployment rate' (i.e the rate below which inflationary pressures start to hot up) sits at around 4.5-5.0%. There's a *very* wide margin of error to that estimate, but the data seem to confirm that the labour market is running close to capacity and wage pressures look set to ramp up further.

What's more, with governments overseas struggling to get a handle on delta outbreaks (with NSW's plight an example), any wide-scale opening in the NZ border still looks like a distant prospect. Accordingly, we see little likelihood of a swift relief to labour market tightness. Sub-4% unemployment beckons in the coming quarters, while core inflation north of 2% looks set to stick around.

Carpe diem

For much of the past eighteen months the RBNZ has emphasised its commitment to a 'least regrets' monetary policy, looking through stronger employment and inflation data while pointing to the remaining downside risks facing the outlook and the fact that upticks in could prove temporary. The RBNZ's thinking was shaped by a fear of tightening monetary policy too quickly and derailing the nascent recovery.

But the resilience in recent inflation and employment indicators is such that the RBNZ's 'least regrets' calculus has shifted 180 degrees. The Bank is now at greater risk of doing too little to stop the coming wage-price spiral and letting inflation exceed the target band for a prolonged period, than of strangling the economy.

What's more, with the Government's tax changes making only modest progress in slowing the housing the market, using monetary policy to cool the market in tandem with the Bank's macroprudential tools looks like a sensible approach. There is little to gain from waiting any longer, but potentially, a fair amount to lose. The decision to suspend the LSAP programme at the last Monetary Policy Review represents a concession to that fact.

There are various approaches the RBNZ could use to normalise rates. **Our core outlook sees the Bank kick things off with a 25bps hike at the August meeting, followed by two hikes of the same magnitude at the two following**

meetings. Such a move would take the OCR off emergency settings by the year (back to where it was pre-COVID), but without the risk of startling markets with a larger cut. **Still, we stress that a faster start to the tightening cycle is very much a live possibility, and a 50bps hike at the August meeting can't be ruled out**.

Whatever the specifics, the direction of travel is clear: the OCR is set to rise over the medium term and, barring a widescale breakout of the delta variant domestically, rise relatively quickly in the short term. Indeed, while we still expect the RBNZ to take a cautious approach over time, the risks to our forecasts are skewed to a faster pace of tightening.

Given how low rates have gotten – and in line with broader long-tun trends – we expect the OCR to stabilise at a historically-low level (we've penciled in 1.5% from the second half of 2022). But once again, the risks here are skewed towards a higher endpoint.

The Bottom Line

The upshot of all of this is that interest rates are set to move higher, faster. Markets have already begun to reflect that fact, with swaps pricing 31bps of rate hikes for the August meeting, and a further 38bps by November. While short term yields have moved dramatically over the past month or so (up circa 30bps) as markets have moved closer to our view, we still see more upside risk than downside. We expect longer term yields to move higher too, albeit not by the same magnitude.

On the retail rates side of things, we've already seen the first lifts in fixed-term mortgages over recent weeks in response to the moves in wholesale interest rates. Based on our own OCR forecast, we expect fixed mortgage rates to lift around 1-1.5% higher over the next two years or so. In short: budget on higher interest rates over the months and years ahead.

To our forecasts, we add a couple of caveats. We still expect interest rates to peak at historically-low levels, and downside risks to the outlook haven't dissipated entirely, even if they've reduced. What's more we still expect interest rates to stabilise at low levels in a historical sense.

Nevertheless, given the direction of travel and the risk of a faster tightening cycle, it's a prudent time for borrowers of any stripe to be examining their interest rate exposures and balancing the need for flexibility with the certainty of locking in rates at their current lows.

For home-owners, make sure you're subscribed to our Home Loan Rate Report for our latest forecasts and analysis of trends in mortgage rates.

For those in the world of commerce, our Corporate Hedging Toolbox aims to make sense of the best strategies for managing interest rate exposures.

For savers, our Term Deposit Report aims to cover the latest developments in deposit rates.

ASB Economics & Research			Phone
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5957
Senior Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5853
Senior Economist	Mike Jones	mike.jones@asb.co.nz	(649) 301 5660
Senior Economist, Wealth	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915
Economist	Nat Keall	nathaniel.keall@asb.co.nz	(649) 301 5720
Data & Publication Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

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